AN INFORMATION REPORT

# The State of State-Local Revenue Sharing

**ACIR** ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

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# Preface

In 1980 attention is again being focused on federal General Revenue Sharing (GRS) because the program must be reauthorized by Congress if it is to continue. In reviewing the program for the Advisory Commission on Intergovernmental Relations (ACIR), the taxation and finance staff also began work reviewing parallel programs operated by the states. This report is the result.

The Commission continues to support strongly general revenue sharing. In the Commission's view it is the preferred federal means for redressing fiscal imbalances in the intergovernmental system. These are the imbalance between the financing ability of state-local governments and the responsibilities they bear, and the imbalance among different abilities of state and local governments to raise revenue. Strengthened GRS, furthermore, is a compelling alternative to the perpetuation of a multitude of fragmented, complex, and narrow categorical aids. A case can also be made in many states for need-sensitive general sharing with local governments. Local governments are likely to be turning more earnestly to states rather than the federal government for assistance, and many states have the fiscal ability to respond.

Indeed, the Commission has advocated general revenue sharing at the state level, and has recommended that general support programs be consolidated and used to accomplish equalization of local financing abilities. A review of 1977 data shows considerable potential for consolidation

and such reorientation of state aid programs. Among the states, 49 had 235 programs of general support for general purpose units of local government. However, less than half of this aid was responsive to inequality among local taxing abilities or needs.

Rather than reviewing aids in all states, this information report is focused on concepts of revenue sharing and on three case study states. An overview of the states' aids, of all types, was provided previously in the 1977 ACIR Report A-59, *The States and Intergovernmental Aid.* Our hope for this report is that the case studies will illuminate how aid concepts have been applied in practice and the results. The three case study states are Wisconsin, Minnesota, and Michigan, where great reliance is placed on sharing with localities and on redressing inequality among local financial abilities.

This study is the first in a series of reports to be prepared by the staff pursuant to the Commission's decision to examine local government finances in the 1980s.

**Abraham D. Beame**
**Chairman**

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# State-Local Revenue Sharing: An Overview

State government policies, even more than federal policies, are important to the fiscal and economic health of cities. States affect their cities in a number of ways, including setting taxation and annexation powers, determining the placement of major development investments and apportioning the financial responsibility for welfare and education expenditures.

The federal government has little or no control over these developments, all of which clearly affect the economic and fiscal health of cities and communities.

The state responsibilities underscore the need for an urban policy which includes the states as full and equal partners. The effectiveness of our urban policy will be enhanced if the states can be encouraged to complement the federal effort.

**President Jimmy Carter**
**The President's National**
**Urban Policy Report***

**P**erhaps the most widely known federal assistance program to aid city governments as well as general purpose local and state governments is federal General Revenue Sharing (GRS). It is not widely known that several states are not only complementing but also exceeding the federal effort by aiding localities through the use of state-local revenue sharing programs. Consider the fol-

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* U.S. Department of Housing and Urban Development, *The President's 1978 National Urban Policy Report*, Washington, DC, U.S. Department of Housing and Urban Development, August 1978, pp. 135–36.

lowing: In 1980 Minnesota localities will receive $91 million in federal revenue sharing. These same localities will receive $246 million in state-local shared revenues. Wisconsin localities will receive $107 million in federal revenue sharing in 1980, but they will receive $474 million in state revenue sharing. Michigan communities will receive $196 million in federal revenue sharing, but here too the federal contribution is exceeded by state revenue sharing of $495 million.

State-local revenue sharing is not limited to the midwest, although it is there where it has become most important as a source of local revenue. Forty-nine of the 50 states have at least one aid program that can be classified as a form of state-local revenue sharing.

## DEFINITION AND IMPORTANCE

State-local revenue sharing can be defined as money given to localities—primarily counties, townships, cities, and villages—to be spent on purposes determined by the localities themselves. The amount and method of allocating aid is determined by the state legislature. This broad definition includes a whole range of state payments, including distributed tobacco and alcohol taxes, state payments for exempted business and personal property tax bases, and revenue equalizing programs with formulas as elaborate as the federal revenue sharing formula. This definition of state-local revenue sharing excludes categorical aids to all local governments and most payments to school districts and special districts since such districts generally must spend all aid in their particular functional area. The definition of state-local sharing also excludes piggyback taxes where there is a local option to tax or to determine the local tax rate.

Using this broad definition, the Census Bureau reports that in 1978, 49 states shared over $6.8 billion with localities. (The Census Bureau's term for state-local revenue sharing is general local support.) This amount represents over 10% of total state aid and is the third largest type of state aid after aids for education and public welfare. When the federal pass-through component of state aid is not counted, state-local revenue sharing is the second in size to education aids.

Between 1958 and 1978, state-local revenue sharing increased nine-fold—from $687 million to $6.819 billion. Even after inflation is considered, this is still a 331% increase.

## REASONS FOR SHARING

States have four principal reasons for instituting sharing programs; primary reasons and methods vary from state to state. State-local revenue sharing originated in many states as a way of compensating localities for property exempted from local taxation or removed from the tax rolls. Examples of such programs include state payments for public utility, personal (household goods, financial assets, business machinery and inventory, farm animals), and government property.

A second rationale for state-local revenue sharing has been to harness the superior revenue raising ability of state tax systems to the local need for more diversified, administerable, and economically responsive revenue sources. This fiscal strategy allows both for preservation of decentralized authority, and, unlike new local taxing authority, also for the extension of significant help to a large number of local governments whose small size, administrative capacity, and lack of wealth in a new tax base might make new taxing authority ineffectual.

Closely related to the second reason for state sharing is the need for property tax relief. When shared funds are used by local governments to hold down or decrease property taxes, the aid to governments also becomes relief for individual property taxpayers.

A final reason for state sharing is the differing need among local governments for revenue and their differing ability to raise it. Given the disparities that often exist between central cities and suburbs, this problem is often most serious in major metropolitan areas. State-local sharing can be designed to provide additional aid to localities with above average public service needs and below average local resources.

There are, of course, alternative ways of dealing with the problems addressed by state revenue sharing. The alternatives range from financial solutions—added local taxing authority, more state categorical aid, or direct property tax relief for individuals—to structural changes like metropolitan governmental consolidation, or state assumption of program financing and operation. The desirability of one approach over another depends on financial conditions and political values within an individual state. State-local sharing, however,

has received little attention—an oversight this report is meant to help remedy.

## THE NATIONAL CONTEXT

Aside from the merits of state-local assistance programs, including state-local revenue sharing in particular, there are national trends that may increasingly motivate state governments to consider use or expansion of state sharing. These trends can shift the capacity to address local revenue and tax problems from the federal government to many state governments. These national trends are worth a brief review.

### Reductions in the Federal Role

Events at the national level indicate that the federal government may be forced to relinquish its major role in solving the problems of cities. Economic, international, and demographic forces may cause the federal government to reduce the level, or at least rate of growth, of federal aids. The federal government has moved from a period of relative fiscal ease to one of fiscal austerity. Among the causes of this new fiscal austerity are the following:

- High inflation that has led the Administration and Congress to try to balance the 1980–81 budget.
- Falling work productivity that has caused many Congressional leaders to call for tax cuts to encourage private sector investment.
- The increasing numbers of Social Security recipients and the decreasing relative size of the supporting workforce that may necessitate a rise in Social Security taxes or a claim on other federal revenues.
- The end to a long period in which the federal government could shift resources from defense to nondefense.
- The open-ended and hard to control federal commitments to domestic health and income assistance.

### Improvement in the Ability of States

While the federal government has entered a pe-

riod of retrenchment, the collective fiscal position of the states has improved since the 1950s and 1960s.

- On the revenue side, most states have strengthened their revenue systems. In 1950, only 18 states made use of both an income tax and a sales tax. By 1978, 37 states were making use of both of these powerful revenue producers—taxes which respond to economic growth far more effectively than does the local property tax.
- Due to the explosive rise in energy costs, the fiscal position of energy-rich states with severance taxes is likely to further improve.
- On the expenditure side, demographic conditions are working for the states and their localities. The decline in student enrollment at the elementary, secondary, and now even the university levels is stabilizing—if not reducing—this important expenditure pressure.

### The Local Constant

The general financial condition of local governments has remained poor. While the most acute fiscal stress is experienced by the major central cities of the northeast and midwest, everywhere there is vocal opposition to increases in property taxes—the main source of local revenues. Reductions in federal aid and continued inflation will increase pressures at the local level for alternative revenues. State-local revenue sharing is one such revenue source.

## ARGUMENTS AGAINST REVENUE SHARING

State-local revenue sharing has not been accepted without criticism. Perhaps the most frequently made argument against state-local revenue sharing, either its initial adoption or its expansion, is similar to that made against all intergovernmental grants-in-aid: if revenue is raised at one level and spent at another, there will be a loss of accountability. Those at the state level who must finance the program will have to answer for the resulting level of state taxes and expenditure, but general sharing precludes the state from being able to control and account specifically for how localities use the funds. Opponents of intergov-

ernmental transfers not only object to lack of direct state accountability, but also believe that local taxpayers may fail to hold local officials accountable for other than locally raised revenues. Therefore, if local officials fail to provide anticipated property tax relief, or spend aid on poorly conceived programs, they may not suffer the wrath of the voters as they would if locally raised funds were misspent. By this logic, there is not only insufficient accountability for general aid, but also there is over spending and taxation.

Many other objections to revenue sharing are related to the resulting interdependence between the state and local governments. For example, once a state has taken on an extensive revenue sharing program, insufficient or maldistributed state aid might be cited locally as a contributor to low local service levels or high property taxes. Locally elected officials might stress that the state must be held responsible for property tax increases or service cutbacks. It may not be clear to local taxpayers who should really be held accountable in what circumstances. What might otherwise be purely local problems, like rising costs, can also become state aid issues. The issues of state aid level, aid management, and methods of aid distribution may compete with direct local problems for the attention of local officials and professional staff.

When pressure is put on state governments to account for uses of aid and to respond to local fiscal problems, new or tighter supervision of local decision making and financial operations may ultimately follow. For example, when a high revenue sharing state government must answer for high state taxes, the theme of state aid as property tax relief is likely to be invoked. Accordingly, the state is likely to consider imposing controls over local spending or property tax levels. It is also possible that expanded general aid may ease the restraint a state would otherwise have toward mandating service requirements on local governments. It should be noted by comparison that local governments seeking state funds are likely to find general revenue sharing far less intrusive than a multiplicity of categorical grants.

States cannot expect that localities' needs and expectations for general aid will turn down when state revenues turn down. Whether economic forces, policy preferences for lower state taxes, or other claims on the state budget are involved, the state may be portrayed as raising property taxes and upsetting local budget plans. Methods of guaranteeing aid flows to localities, on the other hand, can make state budgets less controllable.

If significant aid increases are a prospect, local officials, at least so far, seem generally willing to accept the risks and inevitable state-local strife that can be associated with their increased financial dependence on state government. These officials also point out that regardless of general aid policy, states are already heavily involved in the running of local government. The state government determines local boundaries, local functions and responsibilities, and local revenue sources. Further, many state legislatures have put caps on local revenue raising sources or costs, regardless of state aid policy. Local officials believe that since the state makes the rules, it should also share the costs.

## OUTLINE OF THE REPORT

The chapters that follow explore the current state of state-local revenue sharing. *Chapter II* examines the various ways in which states share revenues. Schemes range from returning state funds directly to the communities from which they come, to sharing systems that try to distinguish among the degrees of need of local governments. Issues in designing a need formula system are given particular attention.

*Chapter III* consists of case studies of state-local sharing in three states: Wisconsin, Minnesota, and Michigan. These states were chosen because of the large amount of state resources devoted to sharing, and because of the considerable experience they have had with sharing programs.

*Chapter IV* is a sample analysis of how the different formulas for general sharing discussed in *Chapters II* and *III* would yield different results in a particular state. *Chapter V* discusses how some states instead attempt to target aid to only a few particularly distressed localities, or to share the tax base among localities only within a key metropolitan area.

From the case studies, *Chapter VI* draws together the pros and cons of state-local sharing. Here are summarized the conditions under which state sharing, or other policies, can be a preferred way to respond to particular problems. The states for which increased revenue sharing may be advisable are identified.

# State Revenue Sharing: Issues Of Design

**B**ecause 49 states now have state-local revenue sharing, many will face issues of how best to distribute revenue sharing funds. In states that may consider expansion, a distribution technique appropriate to their revenue sharing objectives must be chosen. *Table 1* summarizes recent data on the level of sharing by the states. Sharing dollars are classified among methods related to origin, property tax reimbursement, population, other need measures (including tax capacity, tax effort, or other need indicators), and a residual unknown category.

## ORIGIN OR REIMBURSEMENT METHODS

Two traditional methods of sharing state revenues are: (1) by origin of revenue and (2) as reimbursement for taxes lost due to state-authorized property tax exemptions. The 1977 Census Bureau data shown in *Table 1* indicate that 40% of revenue sharing funds were distributed by either of these methods—13% by origin and 27% by reimbursement techniques. Thirty-seven states used origin methods and 29 provided reimbursements. Many of these states employed both methods.

Under the origin system, the state essentially acts as a collection agent for an income, sales, or other tax imposed within all localities. The difference between origin-based sharing and direct local nonproperty taxation is that the state determines the tax rate and structure and applies it

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uniformly across all localities. Problems of tax administration and compliance are minimized by the uniformity, and taxes may be employed that are higher and/or more progressive than a locality might attempt on its own due to fear of tax flight from within its boundaries.

Both the origin and reimbursement systems are conceptually simple and easy for local governments and the public to understand. Return-to-origin systems are also the least objectionable scheme to those worried that state-local revenue sharing means diminished accountability. Aid

*Table 1*

## STATE REVENUE SHARING PROGRAMS: DISTRIBUTION FACTORS, 1977
### (in thousands of dollars)

| State | Origin | Property Tax Reimbursement | Population | Tax Capacity, Tax Effort, or Other Need Factors | Others Not Specified, or Not Classifiable | Total |
|---|---|---|---|---|---|---|
| Alabama | 10,435 | | 6,403 | | 4,440 | 21,278 |
| Alaska | 14,921 | 1,299 | | 16,567 | | 32,787 |
| Arizona | 72,547 | | 79,419 | | | 151,966 |
| Arkansas | | | 17,293 | | 8,234 | 25,527 |
| California | 45,485 | 600,779 | 372,920 | | 78,450 | 1,097,634 |
| Colorado | | | | | 15,564 | 15,564 |
| Connecticut | 8,974 | 45,916 | 7,553 | 13,979 | | 76,422 |
| Delaware | | | | | | NA |
| Florida | 17,831 | 16,900 | 20,914 | | 167,874 | 223,519 |
| Georgia | | | | 13,517 | 2,600 | 16,117 |
| Hawaii | | | | 21,560 | | 21,560 |
| Idaho | | 21,704 | 4,792 | | | 26,496 |
| Illinois | | | 149,347 | | | 149,347 |
| Indiana | 3,703 | 270,406 | 34,977 | | 4,830 | 313,916 |
| Iowa | 3,333 | 164,572 | 26,404 | | 6,012 | 200,321 |
| Kansas | 327 | 14,481 | 10,242 | | 818 | 25,868 |
| Kentucky | | 801 | | | | 801 |
| Louisiana | 34,883 | | | 31,677 | 111,854 | 178,414 |
| Maine | | 2,886 | | 9,888 | | 12,774 |
| Maryland | 24,293 | 17,574 | 19,731 | 14 | 28,334 | 89,946 |
| Massachusetts | 10,868 | 18,654 | | 41,660 | | 71,182 |
| Michigan | 2,184 | 6,286 | 248,124 | 108,569 | 97,943 | 463,106 |
| Minnesota | 15,465 | 85,135 | | 171,258 | 18,730 | 290,588 |
| Mississippi | 66,498 | 7,563 | 750 | | 2,246 | 77,057 |
| Missouri | 1,590 | | | | 3,546 | 5,136 |
| Montana | 1,450 | | | | | 1,450 |
| Nebraska | | 62,537 | 11,623 | | 7,323 | 81,483 |

funds spent, after all, will be sums collected locally, so local taxpayers may be diligent in overseeing their use. If localities press for more aid, local citizens may clearly perceive the link to their state tax level to hold the local units accountable for the tax increase. Reimbursement methods, based either on past revenues collected from an exempted tax base or estimates of what currently would be collected, exist for reasons of "fair play"—that is, to prevent localities with high amounts of exempted property from suffering or to prevent shifting of property taxes to

*Table 1 (Cont.)*

## STATE REVENUE SHARING PROGRAMS: DISTRIBUTION FACTORS, 1977
### (in thousands of dollars)

| State | Origin | Property Tax Reimbursement | Population | Tax Capacity, Tax Effort, or Other Need Factors | Others Not Specified, or Not Classifiable | Total |
|---|---|---|---|---|---|---|
| Nevada | 85 | 280 | 13,190 | | 1,764 | 15,319 |
| New Hampshire | 8,027 | 16,624 | 5,571 | | | 30,222 |
| New Jersey | | 193,947 | | 88,940 | 16,426 | 299,313 |
| New Mexico | 67,243 | | | | 2,083 | 69,326 |
| New York | 296,982 | 650 | | 718,563 | 10,075 | 1,026,270 |
| North Carolina | 33,489 | 330 | 12,096 | | 34,172 | 80,087 |
| North Dakota | 307 | 806 | 2,787 | | 10,971 | 14,871 |
| Ohio | 11,542 | 203,379 | | | 171,915 | 386,836 |
| Oklahoma | 1,080 | 148 | 6,299 | | | 7,527 |
| Oregon | 1,134 | | 21,850 | | 12,592 | 35,576 |
| Pennsylvania | 32,833 | | | | | 32,833 |
| Rhode Island | | 6,198 | 189 | | 4,039 | 10,426 |
| South Carolina | 7,090 | 5,063 | 42,750 | | | 54,903 |
| South Dakota | 103 | 602 | 2,260 | | 1,785 | 4,750 |
| Tennessee | 8,174 | 3,041 | 41,050 | | 8,979 | 61,244 |
| Texas | 15,507 | | | | | 15,507 |
| Utah | | | 1,000 | | | 1,000 |
| Vermont | 133 | | | | 7 | 140 |
| Virginia | 308 | | 20,315 | | | 20,623 |
| Washington | 14,535 | | 27,206 | | | 41,741 |
| West Virginia | 8,276 | | | | 3,981 | 12,257 |
| Wisconsin | 17,712 | | 184,966 | 292,241 | 202,683 | 697,602 |
| Wyoming | 2,813 | 1,152 | 25,186 | | | 29,151 |
| **U.S. TOTAL** | 862,160 | 1,769,713 | 1,417,207 | 1,528,433 | 1,040,270 | 6,617,783 |

SOURCE: U.S. Bureau of the Census, *Census of Governments, 1977, Vol. 6, No. 3, State Payments to Local Governments,* Washington, DC, Government Printing Office, 1979; and Wisconsin Department of Revenue (for Wisconsin data).

other local property taxpayers. Origin and reimbursement methods are also the least objectionable to representatives of the wealthier local districts whose self-interest or local autonomy philosophy argues against redistributive schemes. Neither method is designed to alter or counteract the pattern of taxable resources made available to different localities because of location of tax base.

Other revenue sharing methods are redistributive because funds are sent to localities according to some criteria other than lost tax base or the location of tax base helping to finance the aid. The distribution criteria used may range from population to more complex "need"-related formula packages.

## PER CAPITA DISTRIBUTION METHODS

1977 Census data indicate that 21% of the states' revenue sharing was distributed by population measures. This compares to 40% by either origin or reimbursement methods, and 23% by more complex need measures. *Appendix A*. Thirty states employed the per capita method, usually in combination with other methods.

A purely population-based, state-local revenue sharing system does provide a limited degree of redistribution. State tax proceeds move from high to low per capita income, sales, or other tax base communities. Local inequalities in ability to use the property tax can be modestly offset where high property tax base localities are typically also those with relatively high income, sales, or other shared tax bases. Per capita allocations can decrease the relative advantage of communities with high tax bases, but do not narrow the absolute advantage that wealthy communities have. To illustrate, with a given tax rate, community "A" may be able to raise $100 per capita while community "B" can raise only $50 per capita. Per capita aids of $10 to both communities will narrow "A's" advantage from 2–1 to 1.83–1 ($110–$60) but "A" still retains the $50 per capita advantage. Per capita aids only redistribute substantially when vast amounts of money are involved. This fact has led those concerned with local financing inequality to look for direct measures of such inequality to employ in aid formulas. By using such measures, relatively higher sums (compared to population) can be sent to low tax capacity localities than to high tax capacity localities.

The per capita approach does have the appeal of providing at least a minimum of state aid to each and every locality. Widespread participation makes the aid program attractive politically, and can be justified by appeal to the idea that, regardless of location, every citizen should be guaranteed support for a minimum level of public service.

The per capita approach has an advantage of simplicity, although population estimates must be made and communities may dispute these estimates. Those with declining populations may also object that per capita aids penalize them when their need may be steady or rising. Communities with growing populations, on the other hand, may demand use of the latest population estimates.

## LOCAL NEED FORMULAS

Not only origin, but also per capita methods have been criticized for providing aid to communities that do not really need it. "Local government need" is an all-encompassing term that often goes undefined—at least in part because it is difficult to do so. Actual practice does recognize that "need" has at least two principal component parts. The first relates to inequity in ability to raise revenue locally—i.e., to tax capacity. The second relates to different needs for public spending.

### Ability to Raise Revenue Locally—Tax Capacity

Tax capacity is a concern because communities vary considerably in their ability to raise revenues at a given level of burden on their local taxpayers. These differences are likely to be due as much to happenstance of boundaries, economics, demography, or strategies of development, as to any spontaneous ability of tax bases to expand the most where public service needs are highest.

Since localities rely most heavily on the property tax for locally raised revenue, differences in property tax base per capita receive the greatest attention. For example, if one locality has one-fourth the property tax base per resident of another, it could only raise the same amount of tax revenue per person as the other with a tax rate four times as high.

## EQUALIZING VS. ORIGIN REVENUE SHARING

Equalizing sharing is that which counteracts inequality in local financing abilities by providing relatively more aid to places lacking tax capacity. Proponents of equalization argue that origin-based formulas not only fail to recognize need but also aggravate differences in localities' revenue raising abilities. This is because there is no guarantee that a community disadvantaged in its property tax base will be advantaged in the sales, income, or other tax bases used by the state to raise shared revenue. Rather it is more likely that localities with above average property tax bases will also have above average incomes and retail sales.

This pattern exists because individuals with high incomes tend to live in high value housing. Commercial development that produces sales and excise taxes tends to follow those with high incomes. Industrial development combines high property tax base with high corporate income tax base. As a result, many origin formulas would respond to local tax capacity, but in a perverse way—the better off the community, the more aid.

## PRECEDENTS FROM SCHOOL FINANCE

Advocates of increased equalizing aid argue along lines made familiar in the school finance court cases of the late 1960s and early 1970s: It is unfair for the quality of local public services to be a function of the tax base of the community because this means that residents of tax base rich communities potentially will have high service levels at low tax rates, while those of tax base poor communities will have low service levels or high tax rates. The comparatively poor status of low tax base communities may mean difficulty in attracting new business and residents and may even encourage emigration. Both are circumstances that further erode the tax base and relative attractiveness of the disadvantaged and declining locality.

The advocates of equalization believe that if equalization was legitimate for schools, it is also legitimate for police, fire, welfare, and other local services. State actions to equalize the schools' ability to raise revenue have been far more widespread than programs of equalization for other locally provided services, however. Education is a state function in many state constitutions, while there is no constitutional requirement that the state be responsible for police, fire, and other local services. Thus a distinction can be made between state functions whose service delivery is delegated to localities and purely local services. The advocates of tax base equalization for local services cannot usually maintain that it is legally required, only that it makes good policy.

# Recognizing Varying Needs for Public Expenditures

Measures of relative tax capacity are by themselves insufficient in an aid formula. For example, a locality with half the tax capacity of another should not necessarily receive twice as much aid; it may be smaller in population or expenditure need. Some central cities, on the other hand, may not suffer so much from small tax capacity as from extraordinary costs and public service needs. Measures of size, or need for expenditures, in addition to fiscal capacity must be used in a need-sensitive aid formula.

The argument for considering need factors other than mere population also has had a counterpart in school aid debates. Administrators of central city school districts have maintained that the per pupil cost of educating the urban poor is substantially higher than the costs of educating students in suburban or rural areas. Central city Mayors make a similar case concerning other local government services—that the per capita or per household cost of providing police, fire, and other services in central cities is greater than costs in other jurisdictions, and the characteristics of a locality and its population can increase the need for public services. Neither an origin nor a per capita-based formula, even when adjusted for tax capacity, can be responsive to differences in need for public expenditures.

## PROBLEMS IN DEFINING NEED

State revenue sharing programs as they currently exist frequently combine both measures of tax capacity and need for public expenditure. As such, legislators must choose among, and define these concepts. This issue has been recognized at the federal level in the formula debates for the Community Development Block Grants and General Revenue Sharing programs. Richard E. Nathan writes:

It's not hard to design a formula based on need. There are an infinite number of possibilities but you have to start with an essentially political decision: What dimension of need do you care about?[1]

It should be noted that the problems of picking the appropriate measure are less severe at the state level than at the national level. States are more homogeneous in population, physical characteristics, fiscal practices, and government structure than is the nation as a whole. Diversity in all these types of characteristics, however, is not uncommon at the state level; nearly all states have urban, suburban, and rural areas. The problem of picking the appropriate measures of need, even at the state level, can be formidable.

The dimensions of public expenditure need are indeed complex. The needs of the older central city have been well publicized. However, suburban officials and representatives of newer cities argue that they too have needs created by massive population growth. These officials do not dispute the hardship of older central cities, but they do dispute the wisdom of taking revenues from their own growing areas and redistributing them in what they regard as declining areas.

Rural representatives have their own concerns about measurement. For example, rural areas can be expected to object to measurement of need by levels of local spending or tax effort, because they may be less inclined to solve their collective problems through formal government spending. Rural areas may also have special concern over measures of tax capacity. For example, if rural areas have a high per capita property tax value, this measure, or use of tax rates, may be criticized as failing to recognize low rural income levels.

There are then, as Nathan suggests, a number of dimensions of need and ways to measure them. Is population growth or decline an indicator of need? Do low personal incomes, or lack of ability to raise revenue with a property tax, or both indicate need? How should low income be measured—by per capita income, median family income, percent of population below the poverty line, slow growth in personal income, or by the number of welfare recipients, or aged, or unemployed in a community?

Should the physical characteristics of a jurisdiction be used to indicate need? Such characteristics would include population density, number of overcrowded housing units, and the age of housing. Should the characteristics of population and city physical structure be ignored and attention focused instead on financial characteristics such as taxes levied, tax base, tax rate, total expenditures, or total expenditures for "essential" local services? How can the aid formulas recognize the problems of different government structure, and varying service responsibilities among overlapping local governments?

## Previous Studies

Fortunately, there have been attempts to sort out the various indices of need. Paul Dommel and Richard Nathan of the Brookings Institution[2] and Peggy Cuciti of the Congressional Budget Office[3] have separately categorized the indices of need and discussed the technical problems that are likely to be encountered. While Dommel, Nathan, and Cuciti's writings concern national formulas for federal aid programs, their discussions have equal validity for state-local revenue sharing programs.

Nathan and Dommel identify four principal types of need. They are:

1) **socioeconomic distress,** using factors such as poverty, income level, education, and dependency;

2) **physical decay,** focusing on such problems as obsolescence of infrastructure and condition of the housing stock;

3) **economic development,** using measures such as unemployment, employment growth or decline, value added by manufacturing, and the levels of wholesale and retail sales; and

4) **fiscal conditions,** measuring such factors as budgeting liquidity and the structure of long-term and short-term debt.[4]

Dommel and Nathan have ranked major American cities according to their socioeconomic distress, physical decay, and economic development needs. Cuciti has developed three broad indices using data from Dommel, Nathan, and the Department of Housing and Urban Development combined with calculations by the Congressional Budget Office. Cuciti's three categories are social need, which is related to characteristics of a city; economic need, which is related to characteristics of the physical city and its economy; and fiscal need, which concerns characteristic expenditure levels, revenue base, deficit spending, debt, and taxes.[5]

These attempts to better define need use indices to distribute aids. An alternative method proposed by Kenneth E. Quindry and Don M. Soule in 1970 is for states to distribute aid to local governments on the basis of a regression model that estimates a dollar level of expenditure need.[6]

Quindry and Soule used a model supported by work Roy W. Bahl and Robert J. Saunders did in 1966 and by earlier analyses of the causes of variation in local government spending. Quindry and Soule argue that per capita expenditure variation is positively related to variation in per capita income, per capita wealth, population size, population density, and geographic area.

The state-local revenue sharing formula suggested by the two authors has the amount of aid per capita for a community equal to the difference between its estimated need and an appropriate amount of revenue to be raised locally given a minimum required effort. The political disadvantage of this approach is that no value judgments concerning what are, and what are not valid indicators of need are available; instead needs are represented as average spending levels for communities of similar demographic, economic, and political characteristics. High per capita income and wealth are both two good predicators of local government spending. However, it may be hard to convince legislators to accept a formula that seemingly accepts higher spending levels for affluent communities even though experience shows it is standard and even though the indicators of affluence are entered into the required effort measure so that high ability communities actually receive proportionally less aid than low ability communities.

## Technical Issues

Despite their ability to classify need, Dommel, Nathan, and Cuciti emphasize that the concept requires a political judgment. They also note other problems inherent in the design of formulas for both general purpose and categorical state aid.[7, 8]

Once it is decided to put a variable such as income or taxes into a formula, a choice must be made among the various statistics describing income or taxes. Dommel and Nathan show that if one uses the absolute number of poor people rather than the percent poor, one can come out with different allocations. Cuciti makes the same point by comparing measures of per capita in-

come with the percent of population below the poverty line. Taxes also can be measured in a number of different fashions such as absolute numbers, tax rates, or tax per capita or per household.

Cuciti points out two related matters. First, is the absolute level or the trend more significant to meet the intended purpose of the state grant? Second, does the scale of the index of need adequately reflect actual need? For example, some have argued that density is a good indicator for certain types of public service need. St. Louis has a population density roughly six times that of Kansas City. St. Louis may have greater needs because of high density, but it is a political judgment as to whether St. Louis' needs as a result of density are six times greater than Kansas City's.

A second set of decisions concerns how to combine and weigh data elements. A choice must be made as to whether each part of the formula is to have equal weight or if a certain factor is considered more important and, therefore, given more weight than others. Dommel and Nathan say that the customary approach is to decide what factors ought to be taken into account and then simply to use all of them on a similar basis.

Additionally, one must decide whether the formula is to be multiplicative or additive in nature. Consider the example in *Table 2*, where an additive formula would yield distribution of 50%, 33%, and 17% for cities "A," "B," and "C," respectively.

A multiplicative formula would yield a distribution of 64%, 29%, and 7%. The multiplicative approach rewards needy communities (extreme cases) to a greater extent than does the additive approach but may be less practical politically. Dommel and Nathan note that the logic behind the multiplicative approach is that factors such as poverty and old housing may be far more serious in combination than they are in isolation. However, Dommel and Nathan also raise the issue of collinearity. That is, if poverty and old housing are highly interrelated, then the inclusion of both factors in the formulas may overcompensate for this type of need.

## ACTUAL PRACTICES FOR DEFINING NEED

In designing state-local revenue sharing programs with broad coverage, many states using need-based formulas have avoided the thorny

problems of determining and combining a large number of need and tax capacity indicators. They concentrate instead on simpler symptoms of need.

### Population, Tax Level, and Tax Effort

These states have formulas with the implicit assumption that high expenditures or taxes are caused by economic and social needs. Another reason for this approach is that state-local revenue sharing is a form of tax relief. A conveniently targeted way to reduce property taxes, or so it is thought, is to provide aids to those communities where taxes are high. For example, two basic structures for this type of formula are—

$$\frac{\text{Community Taxes}}{\substack{\text{Statewide Total of}\\\text{All Community Taxes}}} = \text{Aid Factor}$$

or

Equalized Tax Rate × Population = Aid Factor.

The percentage of statewide aid going to a community is equal to the result of dividing the individual community's aid factor by the sum of all communities' aid factors. This percentage is multiplied by the statewide aid allocation to determine the community's dollar allocation.

Of the two approaches, the tax rate type is more sensitive to differences in tax capacity since a tax rate is a function not only of the tax level but also of the tax base. Communities with small tax levies may do poorly under the tax formula, but if some have held their tax level down due to lack of tax base, they may have high tax rates. These com-

munities would do better with a tax rate formula than they would with a tax levy formula.

### Need Vs. Greed

Either formula could make state legislators somewhat queasy. It may be seen as bad enough to give money to localities with no strings; it may be viewed as even worse to give unconditional aids in proportion to taxes levied or tax rates. Such formulas may be seen as rewarding the "big spenders" and providing a potential incentive for communities to increase, rather than decrease, taxes and tax rates in order to obtain more aid.

If high tax communities do not reduce their property tax rate after receiving state-local revenue sharing, they may be regarded with great suspicion by state legislators and by lower tax communities. The high tax communities are likely to argue that their taxes remain high because previously their spending needs were not adequately addressed. Hostile legislators and low tax communities may argue that lavish services, waste, and inefficiency, coupled with the desire for additional aids, keep taxes high. Unfortunately, the truth will be hard to establish and may not be close to either of these polar viewpoints.

There are many reasons why a locality might have high taxes. Some of them are clearly related to need; some, however, may be considered greed; others are difficult to classify. A locality may have a higher than average tax rate because:

1. It has a below average tax base.

2. It has a population and facilities which re-

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quire a larger number of inputs of labor and capital to achieve acceptable minimal service levels, e.g., it takes more police to maintain safety in high crime areas.

3. It is providing services to nonresidents, allowing the home communities of the nonresidents to avoid providing the service.

4. It may not be receiving comparable benefits to other localities from services provided by higher levels of government. It therefore must provide more of its own service.

5. It has higher levels of federal and state mandated services and costs than other localities.

6. It has higher public employee salary and fringe benefits due to hope for higher quality or compulsion from union pressure or the decision of an arbitrator.

7. It has inefficient provision of services, e.g., overstaffing, unnecessary equipment.

8. Its citizens desire higher service levels than exist elsewhere, and public rather than private activity to meet collective problems.

Categories one through five can be thought of as need and it can be argued that state assistance is desirable. Categories seven and eight—inefficiency and chosen high service levels—clearly are not need related. Category six—high salary and fringe benefit levels—is not need-related if it represents a choice. Some would argue, however, that union power or binding arbitration decisions are beyond the local government's power to control.

Not all communities with high taxes, high debt, or unbalanced budgets are needy, and not all needy communities have high taxes or are in financial trouble. This was a major conclusion of the two-year study of 66 American cities recently published by the First National Bank of Boston and Touche Ross and Company.[9]

A legislator may feel that self-inflicted high taxes or fiscal distress should not be rewarded with large amounts of state aid. But there again, he or she might believe that communities with social or economic needs should not receive aid unless fiscal distress is evident. The formula or mix of formulas chosen will reflect that policy decision.

## Needs Vs. Incentives

Formulas that are sensitive to differing tax capacities at any given time are also sensitive to changes in fiscal capacity over time. The aid share of a locality will fall if it builds tax capacity more rapidly than other localities, and aid shares will rise for localities losing fiscal capacity. Such formula dynamics are linked with incentives for economic development and effects of exempting taxable property.

The responsiveness of a formula to changing tax base depends on the type of formula in use and level of aid subject to change, but if there is considerable responsiveness, it will be controversial. On one hand, it may be argued that without such a formula aid, communities incorporate, zone, and compete with each other for development primarily in order to bolster their tax bases and drop their tax rates (i.e., shift property taxes to the new tax base). The argument is that amongst all localities this competition is largely self-defeating and is injurious to the low tax base, high tax rate municipalities. Decisions to welcome new development are thought to be one-dimensional, reflecting only tax rather than other economic, environmental, and social criteria. On the other side, the argument is that a powerful equalizing formula undermines the incentive needed for localities to encourage economic development beneficial to the state as a whole.

Tax capacity-sensitive formulas also interact with tax exemptions. Because tax exemptions can remove more tax base from one locality than another and change its relative tax capacity, the aid formula responds by allocating more state aid than otherwise to the most affected locality. This feedback results in partial statewide sharing of the effects of property tax exemptions, and makes traditional property tax base loss reimbursements or payments for lost property taxes partly outmoded.

## Technical Issues

Even formulas that use relatively simple tax, tax effort, and tax capacity measures raise issues of formula structure, proper measurement, and data accuracy. For example, issues of structure are raised by possibilities for using norms or standards against which to measure relative lack of tax capacity, excessive taxes, or tax rates. The choice of the norm or standard influences the number of localities that can participate in the aid program

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and the distribution of dollars among them. Technical decisions also have to be made about how to actually measure the norm or standard and where to obtain data. For example, data can be averaged from several prior years so that aid payments will not fluctuate too strongly due to a temporary event, but under these circumstances aid payments will be slow to respond to permanent changes in local conditions.

Sometimes data limitations preclude use of certain measurements. Where local property assessment levels differ dramatically, but no state effort is made to develop equalized measures of tax base, related tax capacity or tax rate measures in an aid formula are virtually ruled out. Measurement decisions can also influence local decisions. For example, if measured taxes exclude special assessments and fees, localities may be discouraged from using them as a tax alternative. Further, decisions on how aid is allocated among municipalities and overlying governments like counties can influence how aid levels would respond to reassignment of responsibilities to higher levels, and either encourage or discourage such changes.

### MULTIFACTOR NEED INDICATORS VS. POPULATION, TAXES, OR TAX EFFORT

Measuring expenditure need by a combination of population, taxes, and/or tax effort has its drawbacks. However, it is more feasible and more suited to the equalization objective than combining multiple measures of program need such as poverty levels, substandard housing levels, welfare case loads, unemployment, and so on into a single general need measurement. Measures of specific program need are more workably designed and are more suitable for use in state categorical aids—for housing, welfare, job training, and the like—than for general purpose equalizing aid, a position advocated by the ACIR.

## Politics by Printout

The many possible ways to construct formulas, the many suggestions that will be made to refine need measurement, the complexity and responsiveness of formulas to changing local conditions will raise difficulties in managing such programs and in making aid outcomes understandable to legislators and local officials. Need formula aid systems that apply to many localities could not be managed without the aid of the computer. These conditions have combined to produce what, at the federal level, Richard Nathan calls "politics by printout."[10] If formula revenue sharing systems are adopted at the state level, the same phenomena is likely to spread among more state capitols.

Computers have made it possible to analyze and understand formula systems and to project the effects of proposed changes. However, there are also some negative repercussions. Recipient jurisdictions and legislators can be expected to propose data elements and formula modifications that work to their own advantage. There may be limited resources available to simulate such proposals and varying perspectives on how to correctly portray and interpret the results. As a result, there may be conflict over what proposals are simulated and what the simulations mean. If nothing else, a contribution is likely to be made to legislative information overload.

Secondly, printouts encourage a winner-loser approach to evaluation and voting on a proposal. Some legislators may feel compelled to resist a plan or a change, regardless of statewide merits, if more losers than winners or net dollar losses show up for localities in their districts.

Finally, computer simulations can focus only on a few aspects of the local fiscal landscape, and the accuracy of the results are limited by the quality of data available, programming skill, and the ability to project the future. Decisionmaking by printout can accordingly be swayed by misleadingly precise, but biased information.

## Case Studies

Large-scale formula revenue sharing presents difficulties, and clearly state legislators and governors must weigh the advantages of such revenue sharing against the severity of these difficulties, and the attractiveness of alternative fiscal strategies. Formula revenue sharing is not, however, just a theoretical tool, as the following case studies highlight. The case studies show that major uses have been made of formula-type revenue sharing for over ten years. The next chapter reports on the programs in Wisconsin, Minnesota, and Michigan.

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**FOOTNOTES**

[1] Rochelle L. Stanfield, "Playing Computer Politics with Local

Aid Formulas," *National Journal*, Washington, DC, Government Research Corporation, Vol. 10, No. 49, December 9, 1978, p. 1977.

[2] Paul R. Dommel and Richard E. Nathan, "Measuring Community Distress in the United States," Washington, DC, Brookings Institution, November 1978 (paper delivered to the Copenhagen Workshop on Measuring Local Government Expenditure Needs).

[3] Congressional Budget Office (for the House Committee on Banking, Finance and Urban Affairs, Subcommittee on the City), *City Need and the Responsiveness of Federal Grant Programs*, Washington, DC, U.S. Government Printing Office, August 1978.

[4] Dommel and Nathan, *op. cit.*, p. 11.

[5] Congressional Budget Office, *op. cit.*, pp. 3–10.

[6] Kenneth E. Quindry and Don M. Soule, "Revenue Sharing Between State and Local Governments," *Growth and Change*, Lexington, KY, University of Kentucky College of Business and Economics, Vol. 1, No. 3, July 1970, pp. 8–13.

[7] Dommel and Nathan, *op. cit.*, pp. 12–17.

[8] Congressional Budget Office, *op. cit.*, pp. 11–14.

[9] The First National Bank of Boston and Touche Ross and Co., *Urban Fiscal Stress: A Comparative Analysis of 66 U.S. Cities*, New York, NY, Touche Ross and Co., 1979. pp. 10–11.

[10] Stanfied, *op. cit.*, p. 1977.

# The Growth And Change In State Revenue Sharing Programs: Three Case Studies

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$S$tate revenue sharing programs, as indicated in the previous chapter, are a major vehicle for equalizing local abilities to finance and deliver public service. Indeed, the Advisory Commission on Intergovernmental Relations (ACIR) has taken the policy position that general revenue sharing programs are the preferred means for providing equalization, while categorical aids—aside from general support for public education—have a different function and are the appropriate vehicle to stimulate spending on specific programs.

The goals of equalization and general support for local government have now been merged, both in theory and in fact. This has not always been the case. As the three case studies presented indicate, state revenue sharing programs have evolved from relatively simple methods based on reimbursement, origin, or population. Beginning in the mid to late 1960s, rising local property taxes, service responsibilities, and inequalities in financing ability motivated states to apply more complex need-oriented revenue sharing methods.

The three case studies—Wisconsin, Minnesota, and Michigan—were selected because these states have gone the farthest in their attempt to gauge local fiscal equity. Each case study presents the origin and development of the state revenue sharing program in the respective state. Considerable attention is devoted to the legislative efforts to measure fiscal capacity and to refine the initial index.

As *Table 3* shows, these three states are leading by several measures in general support for local government. As might be expected, the goal of equalizing local ability to provide services sets off conflict between rural-urban and suburban-central city representatives. The case studies conclude with a discussion of the major revenue sharing issues presently being debated.

## WISCONSIN

### Origin and Growth

State-local revenue sharing in Wisconsin dates from 1905 when the state legislature exempted utility property (mainly railroad property at that time) from local property taxation. Using a state gross earnings tax instead, part of the proceeds were used to reimburse communities for their lost tax base. These utility aids have continued, in a much altered form, to the present.[1]

In 1911 Wisconsin initiated the first state individual and corporate income taxes. Their primary purpose was to enable the state to exempt all intangible personal property from the local property tax. To compensate localities, 70% of the proceeds of the state income taxes went to mu-

nicipalities, 20% went to county governments, and only 10% was retained by the state.[2]

Both the utility aids and shared income taxes initially, and for many years, were origin-based revenue sharing. Utility aids went to communities in proportion to their amount of utility property, while personal income tax receipts were disbursed in proportion to the amount of taxes paid by residents of each county and municipality. Since the individual income tax applied only to high incomes, and the exempted property was financial wealth, the new tax base was distributed among localities much like the old base. The origin method of sharing served well as a reimbursement to localities for lost tax base. The proceeds of the corporate income taxes were also distributed according to where corporate income was generated.

As the state's role in the provision of state and local services grew, the proportion of the income tax revenues earmarked for localities was decreased. For example, in 1925 the legislature lowered the shares of income tax from 70% to 50% for municipalities and from 20% to 10% for counties. Dollar levels did continue to rise because the income tax base and rates were increased. As other types of personal and business property were removed from the tax roles, the state ear-

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*Table 3*

## 1978 MEASURES OF GENERAL SUPPORT FOR LOCAL GOVERNMENTS

|  | Wisconsin | Minnesota | Michigan | All States** |
|---|---|---|---|---|
| **General Local Support\*  (in thousands )** | $701,598 | $320,860 | $519,600 | $6,716,418 |
| **Per Capita** | $149.82 | $79.74 | $56.60 | $30.87 |
| **As a Percent of** | | | | |
| **General Revenues** | | | | |
| **of General Purpose** | | | | |
| **Local Governments** | 23.3% | 14.6% | 11.3% | 5.7% |
| **As a Percent of Total State Expenditures** | 14.8% | 6.8% | 5.5% | 3.3% |

\* Excludes payments to schools and special districts.
\*\* Does not include the District of Columbia.
SOURCES and DEFINITIONS: ACIR staff calculations based on unpublished Census data and U.S. Bureau of the Census, *Governmental Finances in 1977–78,* Washington, DC, Government Printing Office, 1980. General local support as defined by the Census Bureau, includes all state payments that are unrestricted in their use. This includes "broad payments of general financial support as well as amounts paid in replacement of specific tax losses."

marked new funds to reimburse local governments. A portion of state motor vehicle license charges and highway user taxes was allocated to communities to replace local property taxes on automobiles. A portion of the liquor tax was distributed to cities and towns based on population.

After 1925 the legislature obtained additional revenues solely for state purposes by attaching surcharges to the income tax and making deductions prior to the local sharing distribution. The state abandoned these subterfuges in 1962 and adopted the principle that the state would receive all the additional revenue that would result from tax rate increases. Localities would continue to benefit from the growth in revenues resulting from increases in income. In order to implement this change, the legislature reduced the percentage of income tax revenues going to local government as the tax rate was increased.[3] Despite the growth in state revenue sharing money, the structure of the sharing continued to reflect the original plan to reimburse localities for property exempted from their tax rolls.

Wisconsin was an innovator not only in revenue sharing, but also with other actions related to property taxes. In 1949 the state introduced an aid formula for school districts that recognized the lack of district property taxing ability compared to a minimum guaranteed valuation per pupil. In the early 1960s Wisconsin instituted a sales tax and used much of the early proceeds to finance a new general property tax relief program. Under this program the state paid a portion of the real estate property taxes for all taxpayers in communities where the mill rate exceeded a state-specified rate. The aid is in proportion to that part of the property tax levy due to a rate in excess of the state-specified rate. A separate, personal property tax relief credit was created for the taxes paid on merchants' stock-in-trade, manufacturers' inventories, and farmers' livestock. A proportional credit was given everywhere, regardless of tax rate. The state also enacted a property tax "circuit breaker" for the elderly called the homestead credit. In 1973 the homestead credit was extended to include all individuals with low incomes.[4]

## 1969: The Tarr Commission

Dissatisfaction with the state-shared revenue policy led to creation of the Task Force on Local Government Finance and Organization in 1969.

Known as the "Tarr Commission" for its chairman, Curtis W. Tarr, the main conclusion of this commission's studies was that the then current system of origin-based aids was needlessly complex and inequitable.

The Tarr Commission said that the revenue sharing system was complex because of the various separate funds involved which necessitated the mailing of eight to ten checks a year to roughly 1,900 units of local government (see Table 4).

The commission found that the origin-based distribution of corporation income tax receipts was a particular administrative burden. Corporations had to maintain special records of income by municipality. Localities were concerned about the accuracy of these records and the accounting practices used to derive them since in 1966 shared corporate income taxes amounted to nearly $42 million.

The Tarr Commission emphasized a second weakness in the Wisconsin revenue sharing program: The method of distributing aids led to inequities as communities that needed aid did not get enough of it and communities that did not need aid received too much. The origin-based system led to local governments with adequate property tax bases being rewarded by disproportionate shared aids, because they were the homes of higher income families and corporations whose taxes were the primary sources of the aids. The Tarr Commission cited examples of communities that received aids many times the size of their property tax levy and noted that "one municipality has sufficient resources to offer two-year scholarships to all of its young people attending college."[5]

### THE LOCAL NEED DISCUSSION

To remedy the defects of the origin-based formula, the commission considered two different approaches to measuring needs. The commission studied but rejected a local expenditure-related formula that would have provided aid to communities which spent above a certain per capita amount for essential services such as police and fire. The commission rejected this approach because it felt that the theory of causation of expenditure levels was insufficiently developed, and the methods of municipal accounting sufficiently varied, as to make this approach unworkable. Instead the commission described its pre-

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## Table 4

## WISCONSIN SHARED TAXES, 1966*

| Tax | Amount Shared | Basis for Distribution |
|---|---|---|
| Individual Income* | $82,418,144 | Origin |
| Utility | 31,057,649 | Origin |
| Corporate Income* | 41,648,214 | Origin |
| Telephone | 6,541,549 | Origin |
| Highway Privilege | 7,805,594 | Origin** |
| Railroad Terminal | 393,328 | Origin |
| Liquor | 7,062,378 | Population |
| Fire Department Dues | 823,768 | Population |
| Inheritance | 1,115,811 | Origin |

* Individual income taxes and corporate income taxes distributed together in three checks annually.
** Highway privilege taxes distributed on basis of number of motor vehicles in a locality.
SOURCE: Task Force on Local Government Finance and Organization, *The Report of the Task Force on Local Government Finance and Organization,* Madison, WI, Executive Office, 1969, pp. VI–1.

ferred alternative—a tax rate type of formula:

A second alternative seems more suitable as a representation of community needs: to assume that the tax rate itself expresses local requirements. This alternative stipulates that a municipality determines its expenditure level, subtracts the revenue it receives from state payments and special charges, and raises the remainder from property taxes. The underlying assumption is that the local elected governing body knows best the requirements of the local government and can balance these against the tax capacity of the community. This alternative may worry critics who fear that prudent judgment will be unable to control spending, but it has the advantage of compensating for the variations between communities which no comprehensive scheme of categorical payments could possibly consider. Furthermore, there is no evidence that general purpose assistance disbursed through the school aid formula has encouraged reckless spending. Thus members of the task force have accepted the willingness of a community

to tax itself as a meaningful gauge of local needs.[6]

The Tarr Commission advocated a consolidated revenue sharing fund from which the new aid distributions would be made and which would replace the general aids then provided on an origin and population basis (that is personal and corporate income taxes, utility and liquor taxes, and motor vehicle registration fees). The size of the fund was to be based on percentages of the same taxes that were shared before. The system for allocating shared taxes was to have three components. The first part was a payment to communities to be determined by multiplying a state-set mill rate by the value of certain types of utility property. There was to be a maximum or cap put on the amount that could be received under this part of the formula. The logic was that utility property paid no property taxes and yet certain utility property received local services, particularly fire protection. It had been argued that the old origin formula provided excessive aid to communities with utility property.

A second part of the formula was to be a per capita payment to all localities, with the amount determined by the state. The logic here was that need for expenditures is primarily, although not

exlusively, a function of population.

The final component was to incorporate the new need measure into the formulas, by providing aid to communities in proportion to the excess taxes caused by having a total tax rate for all purposes higher than a state-specified mill rate. The commission suggested that communities with tax rates below 20 equalized mills should receive no aid; this would have excluded 7% of the communities in the state. This part of the formula was referred to as the "percentage of levies payment." The statewide total payment to offset excess taxes, however, would be limited to the remainder of the revenue sharing money after the special utility and per capita payment had been distributed.

The distribution of aid between counties and municipalities was handled by having each county receive a percentage of what was determined by the formulas for each municipal area in the individual county; the commission suggested 16% of the municipal area amount be given to the county. This arrangement roughly preserved the historic county share. To ease transition problems, the Tarr Commission also advocated that the formula be phased in.

## LEGISLATIVE RESPONSE

At the urging of newly elected Gov. Patrick Lucey, the Wisconsin legislature, in 1971, adopted nearly all of the shared revenue recommendations made by the Tarr Commission. One change, however, was that added annual payments for general property tax relief were provided and funded by deductions from the municipal and county shared tax account. When the new redistributive formulas were enacted, "hold-harmless" guarantees were also superimposed on the system to prevent injury to any locality.

This new need-related formula system did not dramatically increase the amount of revenue sharing and it was not intended to. While total property tax relief-related state payments rose after 1971, most of the growth through 1977 came in

*Table 5*

## STATE PAYMENTS TO LOCALITIES FOR PROPERTY TAX RELIEF AND SHARED REVENUES, 1969–78
### (in millions of dollars where applicable)

| Year | Total | General Property Tax Relief | | Personal Property Tax Relief | | Machinery and Equipment Tax Relief | | Shared Revenues | | Other | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent | Amount | Percent |
| 1978 | $744.2 | $194.4 | 26.1% | $180.9 | 24.3% | $25.2 | 3.4% | $339.7 | 45.6% | $4.0 | 0.6% |
| 1977 | 695.7 | 193.6 | 27.8 | 165.3 | 23.8 | 29.3 | 4.2 | 304.2 | 43.7 | 3.3 | 0.5 |
| 1976 | 664.5 | 183.8 | 27.7 | 154.5 | 23.3 | 32.5 | 4.9 | 290.8 | 43.7 | 2.9 | 0.4 |
| 1975 | 658.2 | 179.3 | 27.2 | 147.8 | 22.5 | 35.2 | 5.3 | 293.3 | 44.6 | 2.6 | 0.4 |
| 1974 | 599.9 | 184.2 | 30.7 | 116.7 | 19.5 | — | — | 296.6 | 49.4 | 2.4 | 0.4 |
| 1973 | 516.3 | 140.4 | 27.2 | 92.1 | 17.8 | — | — | 281.4 | 54.5 | 2.4 | 0.5 |
| 1972 | 461.5 | 88.5 | 19.2 | 85.6 | 18.5 | — | — | 285.8 | 61.9 | 1.6 | 0.4 |
| 1971 | 413.5 | 59.5 | 14.4 | 80.1 | 19.4 | — | — | 272.5 | 65.9 | 1.4 | 0.3 |
| 1970 | 391.7 | 59.6 | 15.2 | 70.5 | 18.0 | — | — | 260.4 | 66.5 | 1.2 | 0.3 |
| 1969 | 371.3 | 51.7 | 13.9 | 65.4 | 17.6 | — | — | 253.1 | 68.2 | 1.1 | 0.3 |

SOURCE: James R. Donohue, "Local Government in Wisconsin," *The State of Wisconsin Bluebook, 1979–1980*, Madison, WI, Legislative Reference Bureau, 1979, p. 216. "General Property Tax Relief" excludes payments to public utilities. "Other" includes fire department dues, severance and withdrawal taxes, and similar minor items.

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**Formula 1**

$$\text{Aid Factor} = \left( \frac{\text{Aidable}}{\text{Revenues}} \right) \times \left( 1 - \frac{\text{Local Property Tax Base}}{(\text{Local population}) \times (\$30,000 \text{ per person})} \right)$$

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general property tax relief, which also used an excess tax type formula. *Table 5* shows that shared revenues as a portion of total property tax-related aids have declined from 1969 to 1978.

## 1975: Closer Targeting for the Need Concept

During its 1975 session, and again at the urging of Governor Lucey, the Wisconsin legislature further developed its revenue sharing system. The major change was to replace the percentage of levies formula with a new one that better recognized differences in local taxing ability rather than tax effort alone. The new formula also keyed municipal or county government aid to its respective taxing status alone, not including the level of school or other taxes.

As illustrated above, the new formula was aidable revenues (a three-year average of most revenues raised by the recipient government) multiplied by a measure of taxing capacity. Taxing capacity was determined by subtracting from one a fraction equal to the ratio of actual full-value local tax base divided by a state standard for per capita property valuation. This latter amount was set at $30,000, over twice the 1976 state average. Communities with per capita property valuation over $30,000 received no aid under this part of the formula, although new hold-harmless provisions prevented actual reductions in aid (*Formula 1*).

For example, if a community had aidable revenues of $1 million, a local property tax base of $75 million full value, and a population of 5,000, its aid factor would equal $500,000. The formula multiplied aidable revenues by 0.5 because the locality was 50% short of the standard set for taxing ability (*Formula 2*). An otherwise identical community, with a larger property tax base of $100 million would have a smaller aid factor, because it was only 33% short of the standard set for taxing ability (*Formula 3*). The actual aid was subject to proration because the sum of the aid factors exceeded the total available funds.

Also associated with the move from a "percentage of levies" to "aidable revenues" formula was a redetermination of the county share. Rather than having county funds set by the municipal shares, the counties began to compete on their own for aidable revenue aids, although only 25% of their aidable revenues were counted in the formula.

## Current Issues

There were three major 1979 issues—(1) the formula, (2) the level of funding, and (3) the impact of formula equalization on the willingness of communities to accept industry.

### THE FORMULA

By 1979 the percentage of levies formula had been changed to aidable revenues, the per capita formula aid had been frozen for three years, hold-harmless payments were no longer fully funded, and general property tax relief growth had been stopped in favor of added direct sharing. These circumstances combined to increase rapidly the money to be distributed under the aidable revenues portion of the formula.

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**Formula 2**

$$\text{Aid Factor} = (\$1,000,000) \left( 1 - \frac{\$75,000,000}{(5,000)(\$30,000)} \right)$$

$$\text{Aid Factor} = \$500,000$$

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**Formula 3**

$$\text{Aid Factor} = (\$1,000,000) \left( 1 - \frac{\$100,000,000}{(5,000)(\$30,000)} \right)$$

$$\text{Aid Factor} = \$333,333$$

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The move to aidable revenues and the consequent greater targeting to low tax base urban areas have not been greeted with enthusiasm by officials in many rural areas and suburbs. *Table 6* shows why. Rural areas are largely unincorporated and the town is the primary unit of local government. Roughly 59% of Wisconsin citizens lives in cities, 11% in villages, and 30% in towns. All three are mutually exclusive.

Towns received over $16 million or 18.4% of the aid allocated in 1975 under the percentage of excess levies portion of the aid formula. They received just over $4 million in 1977 under the aidable revenues portion of the aid formula. The towns' 18.4% share had shrunk to 4.8% in 1977. The losses in total aids were largely offset by the various hold-harmless elements or the formula. It was originally the intent of the legislature to phase out the hold-harmless clauses, but it has renewed them several times.

Nevertheless, further equalization and aid to cities was recommended in January 1977, by the Commission on State-Local Relations and Financing Policy, empaneled by Gov. Patrick J. Lucey:

> The commission recommends that the shared tax program be revised to more nearly equalize disparities between municipalities in the relationship between their available revenue sources and their financial requirements. The shared tax formula should take into account the burden imposed upon central cities in providing services to commuters.[7]

Members of the Wisconsin legislature representing rural districts who were on the commission took exception to this policy statement. They filed a minority report concerning state-shared revenues which said:

> We do not believe it is equitable to the rural areas of the state that state-shared tax payments emphasize the aidable revenue portion of the formula to the detriment of the per capita payment portion. This, in essence, rewards big spenders and penalizes those municipalities which have been efficient or even frugal. . . .
>
> We hasten to add that many services in rural areas, e.g., sewage, water and garbage, are handled by the individual and require little, if any, public expenditures. Nonetheless these persons are entitled to state-shared tax payments inasmuch as they are also a point source of the revenue collected by the state income and sales tax.
>
> If the rural areas are to lose their per capita payments, at the very least those monies should go to expand substantially the homestead tax credit program rather than be consumed by those municipalities which benefit greatly from

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*Table 6*

**"PERCENTAGE OF LEVIES" AND "AIDABLE REVENUE" AIDS, BY TYPE OF RECIPIENT MUNICIPAL GOVERNMENT, 1975 AND 1977**

| | Percentage of Levies Aids 1975 | Percent | Aidable Revenue Aids 1977 | Percent |
|---|---|---|---|---|
| Cities | $62,704,644 | 71.2% | $73,118,706 | 86.8% |
| Villages | 9,189,917 | 10.4 | 7,096,320 | 8.4 |
| Towns | 16,186,354 | 18.4 | 4,035,035 | 4.8 |
| TOTAL | 88,080,915 | 100.0 | 84,250,061 | 100.0 |

SOURCE: Wisconsin Department of Revenue, Bureau of Local Fiscal Information and Analysis, *Taxes, Aids, and Shared Taxes in Wisconsin Municipalities, 1975, 1977*, Madison, WI, Department of Revenue, 1977, 1979, p. 103.

the aidable revenue portion of the formula.[8]

The change from the percentage of levies to the aidable revenue formula increased aids to urban areas at the expense of rural sectors partly because the aidable revenues for municipalities are based only on revenues raised locally by a municipal government and partly because rural property values rose faster than urban values between 1975 and 1977 (Table 7.) The percentage of levies formula gave aids to municipalities based on total county, school, and municipal property tax levies. Since urban areas typically spend much more for municipal services than rural areas, but not much more or equal amounts on schools and county services, switching only to municipal revenues to determine aid acted to the disadvantage of rural areas.

The rural vs. city debate illustrates the different aspects of need, and the difficulty associated with its definition. Although schools are aided separately from municipalities in Wisconsin, rural areas feel that school and overall property tax burdens from any given tax rate are more of a hardship than in urban areas. There is more hardship because of lower rural incomes and because the rapid increases in rural property values lowered

their share of aid but did not provide increased ability to pay taxes. Urban areas, while acknowledging a relative shift in aid to their favor, could argue that their needs remained inadequately met. Table 8 shows that the average per capita amount of shared taxes from all formulas going to towns declined between 1971 and 1977 relative to the amount going to the City of Milwaukee.

Despite the increase that favored Milwaukee and other cities, the municipal property tax rate difference between urban and rural areas of the state continued between 1971 and 1977 (see Table 9).

One way of measuring the equalizing effect of state-shared revenues is to calculate how much property tax and shared revenues a municipality obtained per person, relative to its property tax effort. Municipalities can be compared by examining these ratios of revenue per person to mills of property tax rate. When this is done (as Table 10 shows), Milwaukee remains disadvantaged in 1977 as well as in 1971. While the relative advantage of towns declined between 1971 and 1977, towns still obtained over three times the tax and shared revenue per capita for each mill of tax effort than was obtained by Milwaukee. Put differently, Milwaukee's 1977 tax rate was nearly 12 times the average for towns, but it obtained less than four times as much revenue per person. The relative advantage of other areas over Milwaukee, and of towns and villages over cities, was still substantial in 1979, but the equalizing trend accelerated in the years 1977 to 1979.

The decision of the legislature to continue to increase the aidable revenues portion of the formula represented a commitment to decrease the difference in revenue raising ability among municipalities. In the future, the Governor and legislature will be called upon to reconsider this policy in light of rural and suburban complaints that too many state tax dollars have to be taken from them in order to equalize the ability of higher spending cities to obtain local revenue. In 1979 new Governor Lee Sherman Dreyfus called for a study by the Wisconsin Department of Revenue on the fairness of the aid formulas.

**THE LEVEL OF FUNDING**

The 1977 Wisconsin legislature separated the shared revenue fund (per capita, special utility, and aidable revenues payments) from the general

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Table 7

### PERCENTAGE CHANGE IN "PERCENTAGE OF LEVIES" AND "AIDABLE REVENUES" AIDS, BY TYPE OF RECIPIENT MUNICIPAL GOVERNMENT, 1975 AND 1977

|  | "Percentage of Levies Aids" Per Capita 1975 | "Aidable Revenues" Aids Per Capita 1977 | Percent Change |
|---|---|---|---|
| **Cities** | $22.83 | $26.82 | +17% |
| **Villages** | 19.00 | 13.81 | −27% |
| **Towns** | 11.97 | 2.91 | −76% |

SOURCE: ACIR staff calculations based on Wisconsin Department of Revenue data.

*Table 8*

## AVERAGE SHARED TAXES PER CAPITA INDEXED TO AMOUNT RECEIVED BY MILWAUKEE, 1971 AND 1977

|  | 1971 | As a Percentage of Milwaukee's Allocation | 1977 | As a Percentage of Milwaukee's Allocation |
|---|---|---|---|---|
| Milwaukee | $54.27 | (100) | $72.19 | (100) |
| Cities* | 36.16 | (67) | 56.44 | (78) |
| Villages | 55.70 | (103) | 53.49 | (74) |
| Towns | 40.90 | (75) | 43.70 | (61) |
| State | 50.55 | (93) | 54.46 | (75) |

* Excludes Milwaukee.
SOURCE: ACIR staff calculation based on Wisconsin Revenue Department data.

*Table 9*

## MUNICIPAL PURPOSE MILL RATES,* 1971 AND 1977

|  | Municipal Mill Rate Levy 1970 Payable 1971 | Municipal Mill Rate Levy 1976 Payable 1977 |
|---|---|---|
| Milwaukee | 15.34 | 14.36 |
| Cities** | 7.21 | 8.48 |
| Villages | 4.00 | 5.14 |
| Towns | 1.44 | 1.19 |
| State | 6.34 | 6.11 |

* As equalized to adjust to varying levels of property assessments.
** Excludes Milwaukee.
SOURCE: ACIR staff calculations based on Wisconsin Revenue Department data.

and personal property tax relief programs, and machinery and equipment tax exemption aid. Increases in the level of funding for the shared revenue fund were tied to increases in total state revenue collections with a guaranteed 5% annual increase in the size of the fund and a 12% ceiling on growth. From 1977 to 1978, shared revenue fund payments increased by 11.6%, and for 1978 data collected by the Wisconsin Department of Revenue indicated that municipal governments obtained 38% of their revenues for general operations from state programs compared to 36% from their own property taxes.

Since the 1977 legislature tied aid to general revenues, increases and decreases in tax rates now affect the level of aid within the 5% to 12% floor and ceiling. This change proved important because the 1979 legislature provided a one-time 16% income tax credit, reduced personal income tax rates, and indexed future brackets to increases in the consumer price index.

If Wisconsin had not reduced and indexed personal income taxes, the shared revenue fund would have had $381 million in FY 1980 and $422 million in FY 1981. This would have been a 12% increase in 1980 over 1979 and an additional 11% increase in 1981 over 1980.[9]

Although the shared revenue fund was partially

## Table 10

## EQUALIZATION IN WISCONSIN, 1971, 1977, 1979

| | 1971 Total Levy and Shared Taxes Per Capita Per Property Tax Mill | As a Percent of Milwaukee |
|---|---|---|
| Milwaukee | $10.55 | 100% |
| Cities* | 15.44 | 146 |
| Villages | 22.22 | 211 |
| Towns | 36.61 | 347 |
| Total State | 15.85 | 150 |

| | 1977 Local Levy and Shared Taxes Per Capita Per Property Tax Mill | As a Percent of Milwaukee |
|---|---|---|
| Milwaukee | $16.16 | 100% |
| Cities* | 19.78 | 122 |
| Villages | 24.04 | 149 |
| Towns | 54.37 | 336 |
| Total State | 23.14 | 143 |

| | 1979 Total Levy and Shared Taxes Per Capita Per Property Tax Mill | As a Percent of Milwaukee |
|---|---|---|
| Milwaukee | $23.78 | 100% |
| Cities* | 28.12 | 118 |
| Villages | 31.84 | 134 |
| Towns | 62.49 | 263 |
| Total State | 32.90 | 138 |

* Excludes Milwaukee.
SOURCE: ACIR staff calculations based on Wisconsin Department of Revenue Data.

protected from the tax cut in the original legislation, the tax reduction did lower the growth in the fund to 9.5% in 1980 and an additional 11% in 1981. The revenue loss in each year is over $8 million, totaling to $17.1 million for the two-year period.

The League of Wisconsin Municipalities strongly attacked the reduction in the shared revenue account and helped to persuade the state legislature to add $8.8 million for the biennium.[10]

This would have cut the aid loss in half. Table 11 summarizes the total amount of aids without the tax reduction, with the tax reduction, and with the increased funding proposed by the legislature.

Gov. Lee Sherman Dreyfus vetoed the legislative increases, however, arguing that local government had received a considerable increase in aid without the additional funds proposed by the legislature, and suggested that local governments share the state's austerity.[11] The League of Wis-

consin Municipalities urged an override of the veto, with League Ex. Dir. Ed Johnson charging that the state was financing income tax decreases with funds that should have gone for property tax reduction.[12] The attempt to override the veto failed.

Another funding issue that resulted in a veto by the Governor concerned an appropriation to extend the hold-harmless provisions of the shared revenue account. Because of the increased emphasis on the aidable revenues portion formula instead of the per capita allocation and faster growth in rural and suburban than urban property values, some suburbs and towns would receive less in total shared revenues in 1980 than in 1975. The hold-harmless provisions in effect from 1976 to 1979 were due to expire. The Governor proposed $8.5 million in 1980 to extend the hold-harmless phase out and provide a 75% makeup of aid payment losses. The legislature passed an appropriation of $11 million for 1980 and $12 million in 1981, supporting a 100% level of hold harmless. The Governor argued that this was excessive and vetoed the appropriation. Instead he allowed a one-year, $8.5 million increase and proposed a review of the situation for 1981.[13]

## THE IMPACT OF EQUALIZATION ON INDUSTRIAL LOCATION

The emphasis on equalization, which has characterized Wisconsin public finance not only for general purpose local government finance but also for school finance, has raised an interesting issue: Does equalization, substantial or otherwise, mistreat communities with industrial property and cause communities not to accept or seek an industrial tax base? That is, are localities now so insulated from tax base changes that they can be indifferent or opposed to attracting new industry?

Wisconsin business groups and legislators from districts with high concentrations of industrial property gave the answer "yes." The 1979 legislature and Governor agreed that action was necessary. Manfacturing property, which makes up 5% of the state's property tax base, was excluded from calculations of a community's tax capacity in the aidable revenues portion of the shared revenues formula. Roughly 250 communities with high concentrations of manufacturing property gained aid because of this change. The loss was spread among the remaining 1,600 localities, so the loss to any individual community was not significant.

The legislature had passed a bill excluding 50% of industrial valuation from the calculation of fiscal capacity, but the Governor vetoed the 50% clause, thereby excluding all industrial valuation.

### The Wisconsin Revenue Department Study

In 1978–79, the Wisconsin Department of Revenue studied the issue of equalization and industrial location and focused on two questions:

1. Are there local government costs associated with concentrated industrial

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Table 11

## SHARED REVENUE ACCOUNT, 1979–81
### (in millions of dollars)

| Fiscal Year | Without Tax Reduction | Initial Tax Cut | With Tax Reduction As Passed | With Subsequent Legislative Increases |
|---|---|---|---|---|
| 1978–79 | $340 | $340 | $340 | $340 |
| 1979–80 | 380 | 357 | 372 | 372 |
| 1980–81 | 422 | 399 | 413 | 422 |

SOURCE: League of Wisconsin Municipalities, "1979–81 State Budget, Chapter 34, Laws of 1979, Summary of Major Items Approved and Vetoed Which Will Input on Wisconsin Municipalities," *The Municipality*, September 1979, p. 179.

development which are not recognized in the shared revenue formulas?

2. Does the existence of equalization formulas for school and local government aids cause communities not to seek or to oppose industrial development to the detriment of the economic health of the state?[14]

The aidable revenue portion of shared revenues formula is based on the principle that differences among local property tax rates should be a function of service levels, but not tax bases. What this system did not take into account, critics maintained, was that industrial properties cause a need for additional revenue to be raised per resident because of the cost of municipal services for industry. Further, it was contended that the burden was unfairly placed on the community's residents because the aid formula allows their tax rate to be higher, regardless of where the beneficiaries from industry live.

The revenue department found some empirical evidence to substantiate this claim. Using a multiple regression analysis, the department found that higher than average per capita local spending could be statistically explained in part by high industrial concentration when the latter was one independent variable in a statistical model with other explanatory factors such as total tax base wealth and intergovernmental aids. These other factors were included to control for the possibility that higher per capita spending in industrial communities was due to past fiscal advantages rather than industry per se. The revenue department's analysis further found that the aidable revenue portion of the formula could result in higher tax rates for industrial communities than for nonindustrial communities of similar per capita tax base. The additional aid that they would receive through the formula due to higher expenditure was more than offset by the aid they lost due to their having a higher tax base. This would be unfair if the residents of industrial communities did not themselves benefit substantially from industry-related government spending.

It is difficult to empirically determine the answer to the second issue—whether formula equalization discourages communities from accepting new manufacturing plants. Wisconsin and Minnesota have gone further than other states in equalization of local government finance. Even in these states, however, equalization is not dollar for dollar. Communities do not lose a dollar in aid for each dollar increase in potential tax revenue that comes from tax base growth. The move in Wisconsin from a pro-industrial area aid system to a partly equalizing aid system was also accompanied in 1974 by a property tax exemption for manufacturers' machinery and equipment and, in 1977, by legislation to also exempt inventories over a five-year period. The end result of the exemptions will be to eliminate nearly two-thirds of taxable manufacturing property. Thus, the potential tax base gain from industrial development was considerably diluted over the 1970s. There are no documented cases, however, of a community planning to refuse future permission to industry to build because of a possible adverse effect on state aids.

This problem is in one sense ironic. The intent of state programs to equalize revenue raising abilities has been to create "tax base neutrality," i.e., to make tax rates less influenced by tax base, and to reduce the advantages that high tax base places had in attracting more tax base. As a result some Wisconsin officials now fear that if the local tax base is guaranteed, the willingness of communities to accept industrial development will substantially diminish.

## MINNESOTA

### Revenue Sharing Through 1967

The history of state revenue sharing in Minnesota is comparatively short but intense, with nearly all of the significant legislative actions having been taken in the past 13 years. Prior to 1967 the major shared taxes were:

1. **A tax on alcohol,** of which 30% of the proceeds were distributed to cities and towns on the basis of their population. The tax was first passed in 1934. In 1967 the distribution to cities and towns amounted to nearly $5 million.

2. **A cigarette tax** passed in 1920, of which 25% of the proceeds went to cities and counties on the basis of population. In 1967 this amounted to nearly $7 million.

3. **A bank excise tax and a gross earning tax** which were distributed to communities on

the basis of personal and business property exempted from taxes by the legislature. In 1967 nearly $5 million was distributed to governments under these laws.

4. **Various gift and death taxes** were returned to the county of origin. Slightly over $2.5 million was returned to counties in 1967.

5. **Several taconite and mineral taxes** were returned to the place of origin. Over $2 million was distributed in 1967.

The total revenues shared by the State of Minnesota with its localities was equal to $22.5 million in 1967—over $6 per capita.[15]

Up until 1968, the main emphasis of the state in the area of intergovernmental fiscal relations was school aids, to the virtual exclusion of general aids to local government. In 1967 the state provided nearly $244 million in aids to school districts, close to 11 times the amount of shared revenues provided to cities, towns, and counties.[16]

## The 1967 Property Tax Reform and Relief Act

The sharp rise in property taxes that accompanied the expansion of government services in the 1960s led many states to examine the role of the tax in their state-local financial structure. The 1967 Minnesota legislature passed the *Property Tax Reform and Relief Act* in order to substantially reduce the reliance of Minnesota governments on property taxation.

The centerpiece of the legislation was the enactment of a 3% sales tax to be used to broaden the revenue raising abilities of the state and localities. The legislature eliminated the small state property tax and began a phased elimination of the personal property tax. Approximately $57.3 million of the sales tax receipts were used to reimburse local governments for the resulting loss in revenues in 1968 and 1969—again, an origin-based distribution.

Another major use of the sales tax receipts was the provision of a homestead credit. Through the credit the state would pay 35% of a homeowner's property taxes up to a maximum of $250. Total homestead credit payments in 1969 exceeded $95 million. The homestead credit continues in an altered form today.[17]

Of most direct concern for this study, 25% of all sales tax receipts was to be shared with municipalities and school districts. As a result state sharing for municipalities was nearly doubled. For cities of the first class (Minneapolis, St. Paul, and Duluth), three shares were set aside by the legislature and divided—two-thirds for the city government and one-third for the school district. After the allocation to cities of the first class, the remainder was divided among other cities, towns, and school districts, with half going to cities and towns and half to school districts. The distribution to cities and towns was on a per capita basis. The allocation to school districts was on the basis of the number of school age children in the district regardless of whether the children attended the local public school.[18] Nearly $38 million was distributed under the per capita and per census child allocation in 1968; this increased to $39 million in 1969. The concept of fiscal need, however, was still noticeably absent in the Minnesota revenue sharing program.

## 1970 Events

### CITIZENS LEAGUE STUDY

Local governments, while welcoming state assistance in reducing property taxes, continued to feel that the level of state aid was insufficient. Partly as a result, the 1969 legislature set the amount of per capita and per census child aid at $47.9 million in 1970, with an additional $9.7 million to compensate localities for underpayments in the previous two years.

In 1970 the Citizens League, a highly respected and influential public policy research organization in the Twin Cities, issued a report entitled *New Formulas for Revenue Sharing in Minnesota*.[19] In this report, state policy on general aids to local governments and school districts was analyzed. The league concluded that both the amount and the method of distributing state revenue sharing money were inadequate and further revision of the system of aids was necessary.

In regard to general aids to local government, the study held that property taxes continued to make up too large a portion of total state and local revenues in Minnesota. Underlying this view was the belief that the property tax had problems in uniformity and equity which caused the tax to merit further deemphasis and replacement with

alternative revenue sources.

The Citizens League found that current state policies providing for the per capita aid and homestead credit did not meet the need for alternative sources of revenue. Among the reasons cited for this policy failure was the nature of the per capita formula itself. The study argued that the formula spread the money among so many units of local government that its potential good effect was diluted. The desire of the state to appear even-handed through the use of a per capita distribution was understandable, but the league said it was a mistake to treat unequal localities and units of government equally. Differences in local revenue raising ability and differences in functions of towns, villages, and major cities were cited as inequalities that could not be corrected through the use of a per capita formula.

The league also concluded that general aids to local government were insufficient in comparison to categorical aids to localities and in comparison to aids to school districts. Despite increases in unrestricted aids to general purpose local governments passed in 1967, such aids made up only 6% of total state aids in Minnesota.

Perhaps most fundamentally, a significant difference was found in the perception of property tax relief programs between state and local officials—a difference that continues today. State legislators think of programs that pay a portion of local tax bills, such as the homestead credit and exempt property reimbursements, as aids to local government. Local officials, however, perceive such programs as aids to taxpayers that do not alter local revenue raising ability. The league concluded that whatever their classification, the homestead credit and the exempt property reimbursements alone were ineffective ways of providing property tax relief since they were not sensitive to individual differences in ability to pay the property tax.

## THE NEED CONCEPT

The Citizens League, like the Tarr Commission in Wisconsin, recommended a new revenue sharing formula that incorporated local need as a basis for distributing aid to cities, towns, villages, and counties. The allocation was to be based on the "need" of citizens for public services, the revenue raising ability of the locality, and the demonstrated willingness of the community to tax itself.

No aid would go to school districts under the league's formula; instead all school aids would be consolidated under an improved school aid fund. No aid would go to towns directly; instead the county would receive aids for all unincorporated areas.

The league recommended that the first step in distributing the funds be the division of the fund into two separate pots—one for the Twin Cities metropolitan area and one for the rest of the state. The division would be based on the proportion of local revenues of cities, villages, and towns in the metro area to the state total. Once this division had taken place, the individual community's share would be determined by the average of metro or outstate per capita valuation and metro or outstate personal income per dwelling unit, both relative to the value for the individual community. This result multiplied by the local share of the outstate or metro local revenues would be the aid factor. Thus, the community receives greater aid the greater its share of local revenues and the lesser its per capita valuation and income per dwelling unit (Formula 4).

## REVENUE SHARING, SCHOOL FINANCE, AND PROPERTY TAX RELIEF

A major issue in the 1970 Minnesota gubernatorial and legislative races was property tax reduction, with the primary focus being on school finance reform. The election results indicated that citizens would accept higher state income and sales taxes if the result would be lower property taxes. In 1971 the legislature passed the changes in school finance advocated by Gov. Wendell Anderson. These included a highly equalizing foundation aid formula which made the state responsible for the bulk of school financing; this was labeled the "Minnesota Miracle" by ACIR. The legislature eliminated school districts from the general aid allocation, as the Citizens League had recommended, concentrating school aids in the revised foundation system.

The state also moved to change the local revenue sharing system, incorporating some, but not all, of the Citizens League's recommendations. The state legislature replaced the per capita formula with one based on the size of the local government's property tax levy, except for the division of aid among some suburbs and all county areas. To partially offset the state costs of increased local government aid, the legislature dis-

continued the personal property tax reimbursement and reduced the portion of shared taxes, such as cigarette taxes, going to localities.

Under the new state aid revenue sharing system, each of the 80 outstate counties was designated as a distribution area. The size of each outstate county pot was determined by population and the per capita amount set by the legislature at $25 for 1972 and $27 for 1973.

The county government's share of the pot was determined by its 1971 proportion of the county area aid for exempt property. The remainder of the pot was distributed to cities, villages, and towns based on the size of their property tax levies. The result of the latter part of the formula was to lessen the proportion of aids going to towns, although a "hold harmless" clause protected their absolute level of aids.

The Twin Cities metropolitan area was treated somewhat differently. The entire area was considered as a single distribution area, and the funds available were set by making the per capita metro pot two dollars larger than that of outstate communities—$27 in 1972 and $29 in 1973.[20] A set percentage of the total metro pot was set aside for, and divided among, the county governments on the basis of their respective populations. Special districts were given the amount of aid they received in 1971. Next, funds were divided between the group of suburbs and two central cities, and then between Minneapolis and St. Paul, based on the size of their property tax levies. The funds available for the group of suburbs were allocated according to population.

During the 1971 session, the Minnesota legislature also passed a tax base sharing program for

40% of the growth in commercial-industrial valuation in the seven-county metropolitan area. By the close of the 1971 session, Minnesota had moved away from the early methods of distributing state revenue sharing—origin and population—to a more need-sensitive but complex notion of local fiscal need.

## Adjusting the Need Concepts: 1973–75

A new issue surfaced in 1973 when the Minnesota legislature became concerned that basing local government aids on the size of the property tax levy created an incentive to increase local taxes and spending. As a result the formula was changed so that aid would be divided among communities on the basis of the ratio of each community's levy limit plus special levies to the total such limits in each of the 80 outstate counties or metro area.[21] The 1971 legislature had set a state limitation on increases in levies for certain purposes. The allowable amount of selected levies is referred to as the "levy limit" and the levies not subject to limit as "special levies." The most notable special levies are for debt, pensions, federal and state-mandated programs, and natural disasters.[22]

Any incentive to increase the tax levy to garner additional aids, or any aid penalty from holding down taxes, it was thought, would be removed by basing aid partly on the levy limit rather than actual levies. The limit was not directly under control by the locality because it was based on the prior year limit rather than actual levy. However, the legislature still apparently believed that actual

high tax levies for some purposes indicated high need and, therefore, used actual special levies in the aid ca1culation. Since unlimited special levies account for a sizable portion of total levies, whatever incentive existed to increase taxes in order to increase aids still partly remained.

The 1973 legislature made several more adjustments to the revenue sharing system. The legislature folded remaining shared taxes and reimbursement aids into the formula system, and raised the per capita amounts used to determine the size of the county area allocations. The amounts were set at $35 per capita in 1974 and $36 per capita in 1975 for outstate areas. For the metro area the allocation was set at $36 for 1974 and $37 for 1975.[23] All municipal government allocations were protected by hold harmless provisions, but the level of aid to county governments fell.[24]

The 1975 legislature further adjusted the need concept. The key change adopted was that aids for the following two years were to be based on a formula using population and the equalized three-year average municipal mill rate rather than tax levies. This new formula maintained the system of separate allocation "pots" and froze most county governments at their 1975 level of aid. The exceptions to the latter were Minnesota's three largest counties (Hennepin, Ramsey, and St. Louis), all of which lost general aids as part of a compromise whereby the state increased its own share of welfare costs. The most urban counties, having the largest welfare costs, benefited the most from the increased state responsibility in this area.[25]

Sen. Majority Leader Nicholas Coleman (St. Paul) proposed the change in the formula on the grounds that state aid based on levy limits and special limits gave considerable aids to rich communities, even though only a small mill rate was needed to raise large amounts of revenue in these communities. The Minnesota League of Cities provided the following example:

> . . .Edina levied about $2.2 million in 1974 on a 6.1 equalized mill rate and got $843,000 in local aids. Richfield levied a similar amount and got $863,000 in aids. However, the Richfield equalized mill rate required to raise that amount was over twice as great as Edina's— 13.9.[26]

The league also noted that under the new formula,

were it not for hold harmless, Edina, the state's wealthiest large community, would have its aid reduced to $535,000 while Richfield's allocation would rise to $1,238,000.

The legislature also did away with previous practices of providing slightly more aid per capita to the metropolitan area in its 1975 session. The initial per capita allocation used to determine the size of each pot was set at $42 per capita for 1976 and $45 for 1977.

## 1977: The Central City Issue

The 1977 legislature faced the central city-suburban conflict. The central cities of Minneapolis and St. Paul felt they were not receiving enough aid from the state, but suburban communities held that because the aid formula now responded to actual local tax levies, via the measured tax rate, the central cities were taking advantage of the state by not controlling spending. The legislature responded by altering the formula for Minneapolis and St. Paul so that their aid would be based 40% on the three-year average mill rate and 60% on the three-year average of special levies and the levy limit divided by equalized assessed valuation. Although aid to the cities was made less sensitive to their taxing decisions, both cities were below their levy limits, and the effect was to increase aid to St. Paul since it was further below its levy limit than was Minneapolis.[27]

Additional changes, not affecting the need aspect of the state program, included an increase in the per capita amounts to determine the distribution pots to $52 for 1978 and $59 for 1979. The legislature also altered the formula slightly so that the within-county allocation could be based either on 1970 population or on the average of current and 1970 population. This change was made at the request of rapidly growing localities on the developing fringe of the metropolitan area since their current population was much larger than it had been in 1970.

In sum, the history of state revenue sharing in Minnesota between 1972 and 1979 has been marked by considerable attention to the issues posed by allocating state revenue sharing money on a need basis. This has also been a period of emphasis on formula-type sharing due to large increases under this program. Indeed, statewide payments increased 127% during this period (see *Table 12*).

Table 12

## STATE REVENUE SHARING PER CAPITA IN MINNESOTA, 1972–79

| Year | Outstate Per Capita Allocation | Seven-County Metro Per Capita Allocation | Total Allocation (in millions) |
|---|---|---|---|
| 1972 | $25 | $27 | $ 98.9 |
| 1973 | 27 | 29 | 106.6 |
| 1974 | 35 | 36 | 135.1 |
| 1975 | 36 | 37 | 138.9 |
| 1976 | 42 | 42 | 159.9 |
| 1977 | 45 | 45 | 171.3 |
| 1978 | 52 | 52 | 197.9 |
| 1979 | 59 | 59 | 224.6 |
| **Percent Change 1972–79** | +136% | +127% | +127% |

SOURCE: Minnesota State Planning Agency, Office of Local and Urban Affairs, *Minneapolis-St. Paul Study: Municipal Revenues, Intergovernmental Revenue Section,* St. Paul, MN, State Planning Agency, 1977, p. 50.

## Current Issues: Central City-Suburban Conflicts

While the 1977 legislature made some changes in the allocation formula to reflect the central city problem, this was just an initial response. Prompted in part by the New York City fiscal crisis and in part by concerns over the continuing high level of taxes in the two central cities of Minneapolis and St. Paul, the 1976 legislature asked the state planning agency to study the finances of and government structure in the two cities. The planning agency issued 15 reports on different topics over the course of two years.[28] The major conclusion of the reports was that Minneapolis had a higher tax rate than St. Paul's due to higher expenditures per capita and per household on most city functions. Inasmuch as both are central cities with similar demographic and physical characteristics, it was suggested that need was not the cause.

### THE TWIN CITIES CONTROVERSY

The state planning agency said that the differences in municipal tastes and government structure were the reason for the higher level of expenditures in Minneapolis but also noted:

> The expenditure differences between Minneapolis and St. Paul emerged only in the early 1970s and coincided with substantial increases in state aid.[29]

*Graph 1* shows the increase in Minneapolis' per capita aids advantage over other Minnesota cities between 1971 and 1978. On a per household basis, the difference between Minneapolis and other cities in the state is lessened.

In response to the State Planning Agency statements, Minneapolis city officials argued that the expenditure analysis in the reports was based primarily on 1975 data and that the city had begun, and was continuing, to stem the rise in expenditures through reductions in personnel and administrative changes. City officials also argued that much of St. Paul's lower level of expenditure was due to less rigorous standards of maintenance and physical plant replacement than exist in Minneapolis. Further, St. Paul's lower pension costs reflect its participation in the state pension system which shares unfunded liabilities; Minneapolis was not in the state system. Finally, Minneapolis officials noted that regardless of comparisons between Minneapolis and St. Paul, both cities faced

fiscal disadvantages compared to the suburbs. Even lower spending St. Paul had a much higher tax burden than the suburbs (see Table 13).

The various parties at interest in the state revenue sharing debate were all agreed that the legislature in its 1979 session should change the formula for 1980 and 1981. There was less agreement, however, as to what shape the new formula should take.

## CONFLICTING LOCAL INTERESTS

St. Paul officials desired to lessen the difference in aids per capita between St. Paul and Minneapolis and wished to do away completely with aids based on mill rates. St. Paul Mayor George

*Table 13*

### PAYABLE 1976 EQUALIZED MUNICIPAL MILL RATES IN THE MINNEAPOLIS-ST. PAUL AREA

| | |
|---|---|
| **Minneapolis** | **38.728** |
| **St. Paul** | **26.740** |
| **Metro Suburbs with population of 10,000 or more** | **13.365** |

SOURCE: Minnesota State Planning Agency, Office of Local and Urban Affairs, *Minneapolis-St. Paul Study: Final Summary Report,* St. Paul, MN, State Planning Agency, 1978, p. 125.

*Graph 1*

## LOCAL GOVERNMENT AID PER CAPITA, BY RECIPIENT MINNESOTA CITY, 1971–78
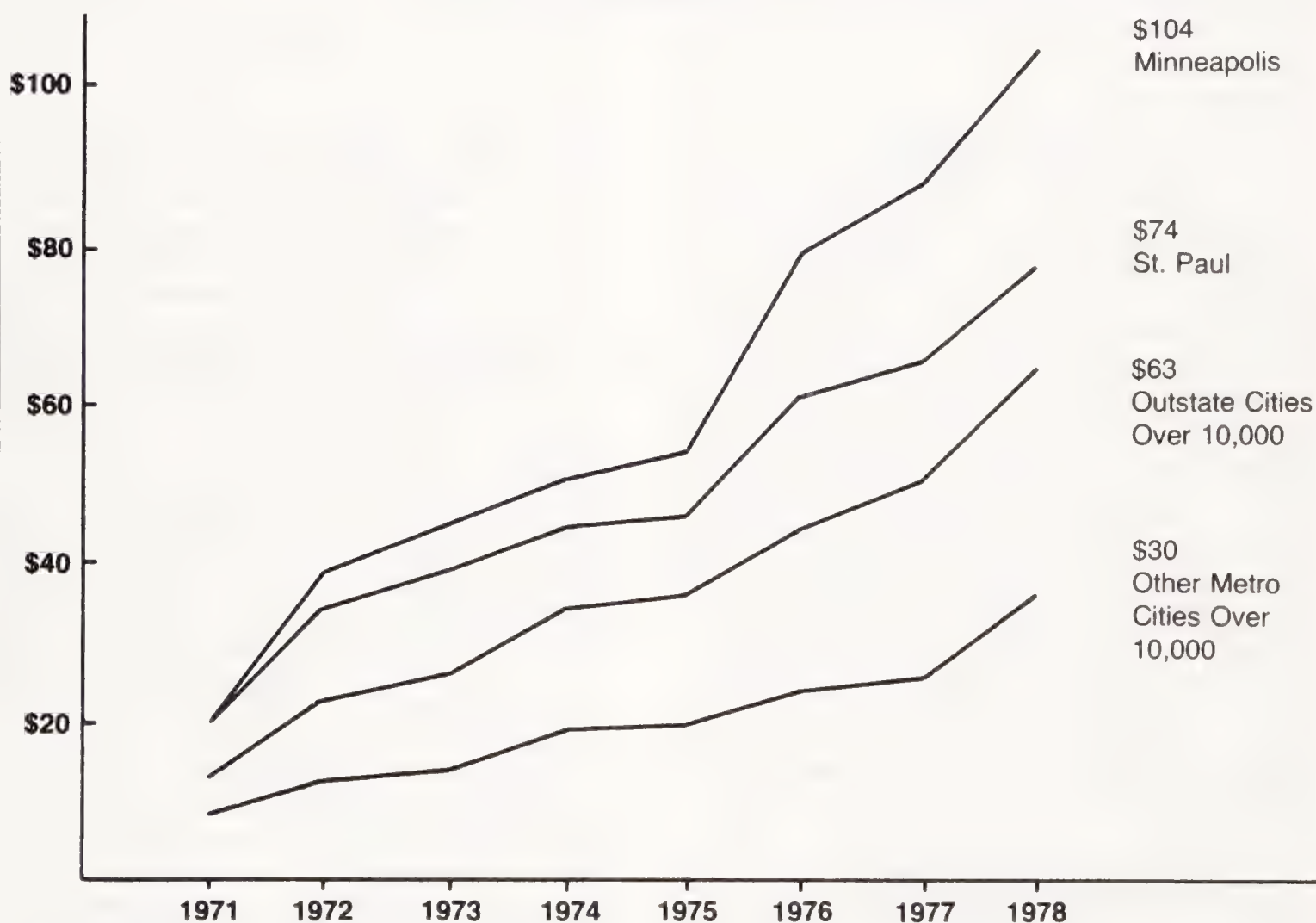


$104 Minneapolis

$74 St. Paul

$63 Outstate Cities Over 10,000

$30 Other Metro Cities Over 10,000

SOURCE: Minnesota State Planning Agency, Office of Local and Urban Affairs, *Minneapolis-St. Paul Study: Final Summary Report,* St. Paul, MN, State Planning Agency, 1978, p. 24.

Latimer argued that the recent rise in property taxes in his city was necessitated by the relative loss in aids that resulted from previous tax cuts. Officials in St. Paul wanted a formula that placed more emphasis on tax base equalization rather than expenditures since the city had a lower assessed valuation per capita than Minneapolis and suburban localities.

Suburban officials and legislators wanted a formula which was more responsive to changes in population and which reduced the share of aids going to Minneapolis.

Minneapolis, for its part, did not oppose the demise of a formula based on property tax mill rates, for the city had reduced its tax rate in each of the two previous years and was planning a third year of property tax rate reduction. The city's main concerns were that population be deemphasized as a method of allocation and that the city obtain pension relief. City officials were cognizant of the fact that a population loss of 15% had taken place since 1970, although the number of households had remained fairly constant. The city's rate of population loss between 1970 and 1978 was one of the most rapid in the country and while there was a leveling-off trend, city officials feared the drop in aids that would result if forced to use their 1980 population figures for aids in 1982.

The city's pension problem also caused alarm. All nonuniformed local employees in the state are included in the statewide public employees' pension plan except nonuniformed Minneapolis city employees. The sharing of unfunded liabilities in the state system allowed the other older cities to avoid much of the tremendous cost of unfunded liabilities. Minneapolis officials expressed a willingness to forego an increase in aid for 1980 if the Minneapolis nonuniformed plan could be merged with the statewide plan and their unfunded liabilities shared.

## A COMPROMISE FORMULA

Two study groups also expressed an opinion on a new formula. The Municipal Finance Commission, a group of public officials and businessmen impaneled by Minneapolis Mayor Albert Hofstede to advise him on the city's financial situation, called for a formula that incorporated measures of socioeconomic need.[30] The Citizens League made a similar recommendation urging the legislature to:

> Consider characteristics such as fiscal capacity, age of housing, poverty population, and other factors beyond cities' control as possible substitutes for the "need" measure in the municipal aid formula.[31]

The Citizens League said that it found no evidence that the existing formula led to higher spending by local governments. It noted that if St. Paul set out to increase aids by $1 million over a three-year period, it would have to increase taxes by $6.6 million during the three years, assuming all other communities had constant taxes and population. Still the league argued it was advisable to remove the "appearance of rewarding spending."[32]

The group most interested in formula change was the Minnesota League of Cities. Under its auspices, St. Paul Mayor Latimer proposed and the other cities accepted a three-part agreement. Parts of this compromise were that Minneapolis would receive no increase in aids in 1980 and that pension relief for Minneapolis would be supported. The basic formula for aids for cities with populations in excess of 2,500 would be:

$$\text{Aid Factor} = (\text{Levy Limit} + 1979 \text{ Aids}) - \left( \begin{array}{c} \text{What 10 Equalized} \\ \text{Mills Would Raise in} \\ \text{the Community} \end{array} \right)$$

The levy limits of Minneapolis and St. Paul would be reduced 15% in order to lessen the size of future amounts that would be counted in the formula. Including aid in the formula would have expanded the measure of need beyond the tax level toward a more inclusive measure of costs and overall spending.

This package soon hit a snag. It became obvious that the legislature was unwilling to merge the unfunded pension liabilities of Minneapolis with the state because of opposition of public employee unions and because Minneapolis' large unfunded liability reflected benefit levels higher than provided by the state plan. It was also felt that Minneapolis was not giving up enough in future aids to make up for increased state cost.

This conflict was resolved by having only the new nonuniformed Minneapolis employees as part of the state pension plan. No merger would occur for existing employees and unfunded lia-

bilities. Instead the state would provide direct aid to the city's pension fund to offset the higher costs borne by Minneapolis taxpayers not associated with better benefit levels.

## STATE REVENUE SHARING IN 1980 AND 1981

The proposed formula was adopted with slight changes. Aids for 1980 will be based on the total of the 1979 levy limit plus 1979 aids minus what ten equalized mills would raise. An adjustment is made for communities that do not levy property taxes for refuse collection and street maintenance so that special assessments or user charges for these purposes are added to the base. Hennepin, Ramsey, and St. Louis County governments will still receive no per capita aid while all other counties will receive a one dollar per capita increase. All cities and towns with a population in excess of 2,500, except Minneapolis for 1980, are guaranteed an increase of:

$1 per capita for three-year equalized mill rate = 0 to 10

$3 per capita for three-year equalized mill rate = 10 to 20

$5 per capita for three-year equalized mill rate = 20 or more

A sliding scale ceiling is put on increases in aids, with a 12% limit for communities whose 1979 aids exceeded $100 per capita up to a 20% limit for communities receiving less than $50 per capita in aids.

Aids for 1981 are to be determined in the same fashion except that the revenues counted in the formula for each locality are to be adjusted upward for inflation and population increases. It is not adjusted downward for decreases in population. Additional adjustments are to be made for 1980 debt service property tax levies for the replacement of sewers, streets, curbs, gutters, bridges, and storm sewers.[33] Each year the amount which ten equalized mills will raise for each community will also have to be recalculated.

The new formula eliminates the separate distribution pots; all communities in the state, except for those exempt from the levy limitation (an 8% limit on increases in the maximum levy for most general purposes), are now in direct competition with one another. Almost all of the towns, plus the cities under 2,500 population according to the latest federal or state census, are exempt from the levy limitation. These local units receive aid increases, if any, strictly on the basis of the level of their average equalized mill rates, and are not in competition with one another.

In the design of the new formula, the legislature and interested parties obviously attempted to provide something for everyone. Fiscal capacity is emphasized rather than tax effort, and whatever aid-related incentive there was to increase taxes is eliminated. The formula rewards population gain but does not directly punish population loss. Because of the various floors, ceilings, and annual adjustments, and the fact that Minneapolis will be eligible for aid increases in 1981, it is difficult to project future allocations under the new formula. The legislature has appropriated $246 million for 1980, and given the recent pattern of substantial increases, state revenue sharing in Minnesota should continue to be a major policy issue for state and local officials.

# MICHIGAN

## Revenue Sharing Origins

General state aids to local government in Michigan originated in the 1930s. Following the repeal of prohibition in 1933, the state began taxing enterprises that held alcoholic beverage licenses, with the bulk of the receipts distributed to local governments on the basis of origin. The 1939 state legislature added to the local government "pot" when it gave localities a portion of state intangible tax receipts, on a per capita basis, to replace the revenue lost from a recently adopted intangible property exemption. Intangible taxes were levied on banks, insurance companies, and other financial institutions. The state also paid the full dollar loss suffered by localities as a result of the veterans' homestead exemption, also adopted in 1939. The exemption originally applied to all veterans of World War I and required the state to pay the taxes on the first $2,000 of equalized value of the veterans' homestead up to a given income level. The exemption was extended to veterans of later wars as well.[34]

The replacement of revenues lost by local governments and the sharing of state revenue sources during the 1930s represented a departure from previous Michigan practice. In 1905 the state exempted utility property from taxation but did not

share the new utility taxes with localities. The state sales tax, passed in 1933, also remained an exclusive preserve of the state.

## The Search for Alternative Revenue Sources

### THE 1946 INITIATIVE

The absence of a major state revenue sharing program, coupled with restricted local tax bases and a cap on tax rates (made part of the Michigan Constitution in 1932), led localities to press for new revenue sources. In 1946 the Michigan Municipal League, prompted by "the continued failure of the legislature to act," joined a successful initiative campaign to amend the state constitution to require that a portion of state sales taxes be returned to cities, townships, villages, and school districts.[35] Concerning payments to local governments, the amendment said:

> There shall be returned to local governmental units by the method hereinafter set forth, one-half cent of a state tax levy on each dollar of sales of tangible personal property on the 1946 statutory base (not rate). The state disbursing authority shall remit to counties as a whole on a population basis and payment shall be made to the county treasurer who shall remit to the respective cities, townships, and villages within the county on a per capita basis. Population computation shall be based on the last and each succeeding statewide federal census for purposes of division among counties and upon the same basis or upon any special federal countywide census, whichever is later, for intracounty division purposes.[36]

The amendment also allocated two cents of the state sales tax to school districts.

The 1951 Michigan legislature, however, partially offset this expansion in local revenue sources by placing an $11 million ceiling, lowered to $9.5 million in 1952, on the state reimbursement for the intangible property tax exemption. Henceforth, the state would keep a larger portion of the revenue derived from statewide intangible taxes.

### THE 1963 STATE CONSTITUTION

Between 1961 and 1963 delegates to a state con-

stitutional convention drew up a new constitution for the State of Michigan. Localities had two major victories in the new constitution that was approved by the voters in 1963. First, the mandate for sharing of state sales tax revenues with local governments was continued. Section 10 of Article IX states:

> One-eighth of all taxes imposed on retailers on taxable sales at retail of tangible personal property shall be used exclusively for assistance to townships, cities, and villages, on a population basis as provided by law. In determining population the legislature may exclude any portion of the total number of persons who are wards, patients, or convicts in any tax-supported institution.[37]

Localities' second victory concerned the grant of broad taxing authority to cities contained in Article VII, Section 21. The article says in part, "Each city and village is granted power to levy other taxes for public purposes, subject to limitations and prohibitions provided by this constitution or by law."[38]

This broad grant of authority was short-lived for the legislature quickly exercised its option to limit and prohibit local taxes. The state effectively limited local governments' choice of new taxes to a single option—a uniform city income tax. The power of local governments to levy excise taxes, which stretched back to 1909, was revoked.[39]

### 1967: THE NEW INCOME TAX WITH PER CAPITA SHARING

The 1967 legislative session was a turning point in state-local fiscal relations. The legislature passed and the Governor signed a bill enacting a state personal income tax. At the same time, a portion of the revenue was earmarked for localities. Under the personal income tax bill, 11.5% of the gross proceeds of the tax were earmarked for localities, with 50% of this amount going to county governments and 50% going to cities, villages, and townships, all on a per capita basis.

The increase in revenue sharing with local governments, however, did not significantly reduce the tax burdens on local taxpayers as it coincided with a rapid increase in local spending and taxing. As *Table 14* indicates, between 1967 and 1971 local property taxes in Michigan increased

*Table 14*

## LOCAL PROPERTY AND INCOME TAXES IN MICHIGAN, 1967–71
### (dollar amounts in millions)

| Year | Local Property Taxes | Percent Change | Local Income Taxes | Percent Change | Percent Change C.P.I. | Percent Change Michigan Personal Income |
|------|------|------|------|------|------|------|
| **1967** | $1129 | — | $ 60 | — | — | — |
| **1968** | 1289 | +14% | 70 | +17% | +4.2% | +11% |
| **1969** | 1475 | +14 | 112 | +60 | +5.4 | + 8 |
| **1970** | 1660 | +13 | 130 | +16 | +5.9 | + 3 |
| **1971** | 1874 | +13 | 123 | − 5 | +4.3 | + 9 |

SOURCE: Michigan Department of Treasury, *Annual Report,* Fiscal 1972, Lansing, MI, Michigan Department of Treasury, 1972, p. 71

at a rate two to three times the increase in the consumer price index, and at a rate faster than the growth in the state's personal income. The growth in local income taxes was also substantial, although revenues in 1971 were affected by the economic slowdown in 1970.

Even with the rise in tax revenue, several of the state's older cities were fiscally pressed. Gov. William Milliken persuaded the legislature to make a $5 million grant to Detroit in 1970 to help alleviate that city's fiscal crisis.

## The Revenue Sharing Act of 1971

Both Governor Milliken and the Michigan Municipal League recognized the necessity of changes in the state's revenue sharing system. In 1971 Milliken proposed no increase in aids over their expected growth, but argued that some aids be distributed in proportion to individual municipal tax levies. The Michigan Municipal League suggested that an appropriate aid formula would include three factors:

> ... (1) the need for municipal services, as measured by population; (2) the local tax burden, taking into account overlapping school and county as well as direct local tax levies; and (3) the ability to pay

for municipal services as measured by state equalized value.[40]

The league also proposed a $50 million increase in aids over and above the growth the current earmarking would provide. Thus, the state was beginning to move to a need-related measure for distributing its state revenue sharing.

The changes proposed by the Governor and the league, however, were opposed by county and township officials. The former objected to the exclusion of counties from aid increases, while the latter recognized that townships with their low municipal taxes would be disadvantaged by a "tax effort" factor.

The legislature responded with a compromise formula that incorporated the elements suggested by the league and provided nearly $19 million in additional aids over and above the expected growth. The legislation, called the Revenue Sharing Act of 1971, combined the three major existing shared revenue programs and guaranteed that each city, village, and township would receive at least $16.50 per capita in total aids.

One-eighth of shared sales tax receipts would continue to be distributed to cities, villages, and townships on the basis of population, as the 1963 Michigan constitution required. For FY 1972 roughly $107 million in sales tax receipts were shared in this manner.

The 11.5% of state income tax receipts available for sharing under the income tax legislation would continue to be evenly divided between municipalities and counties. The county share would be distributed on a per capita basis. Allocations to municipalities would, in 1972, be made according to an equalizing formula based on local tax effort.[41]

Effort was to be measured by the ratio of municipal tax rate levied in a jurisdiction to the statewide average tax rate. This rate includes all non-school property, excise, and income taxes, except that the income tax amount would be adjusted downward to reflect the contribution made by nonresidents. The total adjusted taxes would be converted to a tax rate by dividing the amount of taxes by total equalized property valuation in the community. This tax rate would then be compared to the statewide average with the ratio multiplied by community population to determine the local share of the $36 million in funds for 1972.[42]

The third source of shared state revenue—intangible taxes—had been frozen at $9.5 million in the early 1960s. Under the 1971 Revenue Sharing Act, 45% of the proceeds of the intangible tax, plus $14.5 million, would be distributed to localities. The $14.5 million would be distributed on a per capita basis to cities, villages, and townships, while the 45% of the proceeds was to be distributed according to the tax effort formula. The total intangibles tax distribution exceeded $35 million in 1972.

Beginning in 1973, the tax effort formula for distributing shared personal income tax aids and intangible aids in excess of the $14.5 million was to be changed into a "relative tax burden" formula by also including the taxes of overlapping governments, the county, school districts, and special districts. The primary beneficiaries of the tax burden formula change would be townships and suburban cities, both of which had low taxes for municipal purposes.

Counties, in addition to the amount that they were to receive under the existing shared personal income taxes, were allocated additional aids from the general fund, which also were to be distributed on a per capita basis.

The legislature originally intended to change in 1973 from the "tax effort" formula in use in 1972 to the "tax burden" formula. The difference between the two different formulas partly reflected two views on the purpose of revenue sharing. Revenue sharing can be seen as a direct aid to local government and as an indirect aid to local property taxpayers. The tax burden formula would reward municipalities if the total level of taxes paid in a community to all local units of government was high. Although the municipality receives all of the shared revenue, it is only a part of the local tax bill. The municipality could use such aids to reduce its own tax rate and in part compensate taxpayers for the above average taxes levied by overlapping units of government.

The two functions of revenue sharing are related to two different ways of measuring local need. If revenue sharing is intended primarily as an aid to taxpayers, then the overall tax burden is the appropriate measure of need. If revenue sharing is intended primarily as an aid to local governments, then the financial characteristics of the individual local government is the better measure of need.

In 1972 the legislature decided instead to supplement rather than replace the relative tax effort formula with the relative tax burden formula. Municipal government taxes counted in the tax effort formula were redefined to exclude special assessments. The relative tax burden measure would include municipal taxes, special assessments, and 25% of the taxes of overlying jurisdictions such as the county and school district. The same measure of tax capacity was used in both formulas. Communities that would receive more under the relative tax burden formula were to receive a supplemental check for the difference between the two formula allocation amounts. The amount of the supplements was an add-on to the conventionally determined sharing amounts. The legislature also provided for more rapid disbursement through quarterly distribution of shared sales and personal income taxes as they were collected.

By FY 1973, the state revenue sharing program was largely "in place." A total of $213.65 million was shared by the state with cities, villages, and townships in the following manner:

- sales tax, per capita formula, $126 million;
- intangibles tax, per capita formula, $14.5 million;
- intangibles tax, effort formula, $15.6 million;
- state personal income tax, effort formula, $47.65 million;

- general fund, tax burden formula increment, $4 million; and
- general fund, minimum guarantees, $5.9 million.

Counties received their share of income tax receipts which amounted to $47.65 million.[43]

## Expanding State Revenue Sharing: The 1975 Session

In January 1975, Gov. William Milliken announced his support for further increases in state revenue sharing, and increases in the portion of the state personal income and intangible tax receipts going to municipalities. The Governor asked the legislature for an additional $16 million in shared intangible taxes and a reallocation of $5.7 million in shared personal income taxes to municipalities from counties. The Governor had also asked for increased state assumption of county welfare costs as part of the package. Partially offsetting the overall rise in recommended state aids was a proposal by the Governor to eliminate the roughly $8 million necessary to finance the relative tax burden supplemental payment.

The Governor's recommendations provoked immediate opposition by legislators from communities receiving relative tax burden supplemental payments. Further, the feasibility of welfare cost assumption was jeopardized by the effects of the economic recession; welfare caseloads were rising faster than had been expected while the state's revenues were not keeping pace.

As a result of the conflicting desires of legislators from different communities and the fiscal constraints caused by the recession, the legislature agreed on a less ambitious package. The compromise included a phased reduction in the county share of income tax receipts with the counties' loss being the municipalities' gain. Initially this would increase municipal aids by $4 million, with further increases as the county-phased reduction became complete.

The major innovation of the 1975 session was the adoption of the single business tax. This tax replaced the corporate income, franchise, and inventory taxes and that part of the intangibles tax which was a shared tax. The legislature decided to cut shared intangible taxes back to $9.5 million, with this amount again to be shared on a per capita basis. The loss in shared intangible taxes was

more than offset by the legislative decision to share $35 million in single business tax revenues to be distributed according to the tax effort formula.

Growth in revenue sharing, via the single business tax, was also made "automatic." Although the total amount of single business tax revenues would remain at $35 million for both FY 1976 and FY 1977, future shared single business tax revenues would be pegged to the rise in this revenue source starting in 1978. That is, localities were to receive a fixed share (percent) of a growing revenue source.

Another portion of the single business tax was to be used to provide dollar-for-dollar replacement of revenues lost by localities due to exemption of business inventories under the single business tax legislation. This amount was apportioned on the basis of the 1975 valuation of business inventories multiplied by the current rate of local tax effort.

To achieve the broadest possible support for the aids package, the legislature decided to maintain the relative tax burden formula supplemental payment, but capped it at $3.5 million. The legislature also initiated a new supplemental payment for those communities that had experienced population growth over 15% between 1970 and 1975. The 1970 Census data were the basis for per capita allocation and were also used in the calculations of tax effort and burden allotments. Fast growing communities, particularly developing suburbs in the Detroit metropolitan area, were disadvantaged by the use of 1970 data.

In the fall of 1975 it became apparent that the economic recession was having a greater than anticipated impact on state revenues. The state had expected downturns in certain of its revenues but the reduction was greater than projected. Since the bulk of funds in the state revenue system were earmarked portions of tax receipts, the downturn also impacted adversely on local revenues.

Governor Milliken found that the revenue shortfall would leave the state's total budget out of balance and he was constitutionally required to reduce expenditures to maintain a balanced budget. He therefore exercised derivative executive budgeting powers to eliminate the supplemental relative tax burden and special census payments. The total amount of revenue sharing in 1976 was 7% more than the amount shared in 1975, but it was 6% below the amount originally

budgeted. Thus, the experience of Michigan municipalities serves notice that when localities share in state revenues, they must expect reductions when those revenues decline.[44]

## The Detroit "Equity" Payment: 1976

The 1976 session, at Governor Milliken's urging, gave special attention to financially stressed Detroit, but not as part of the state revenue sharing system. Detroit Mayor Coleman Young had long argued that a large portion of the city budget went to providing services to suburbanites who work or make use of cultural facilities in the city. Governor Milliken and Mayor Young reached agreement on legislation to provide a $27.8 million "equity payment" to Detroit for FY 1976 to compensate the city for services rendered to nonresidents. The equity payment for 1977 was increased to $30 million.[45]

Increasing aid to Detroit has been a major accomplishment of the Milliken administration in the face of the mutual hostility that exists between Detroit and other parts of the state, especially Detroit's suburbs. The distrust that exists between a state's largest city and other residents of the state—which also exists in Minnesota, Wisconsin, and many other states—is heightened in Michigan because of the racial differences that tend to differentiate Detroit from the state as a whole. Other attempts by the Milliken administration to bring about tax base sharing and a degree of consolidated metropolitan government, similar to that existing in the Minneapolis-St. Paul metropolitan area, have floundered on the animosity that characterizes the relations between Detroit and its suburbs.

## The Urban Grant Program: 1977 to 1979

In 1977 Governor Milliken proposed that an additional $12 million be appropriated in temporary urban grants to financially needy local governments. However, the enabling legislation did not pass until the following year when a larger $24 million appropriation was agreed upon. Half of the $24 million appropriated for 1979 was distributed to cities with a local personal income tax in proportion to their income tax collections excluding nonresident payments. The remaining $12 million was shared among all municipalities

in the state able to meet the eligibility criteria— low per capita income, high property tax rates, and assessment practices reasonably near the state standard of 50% of sales value.

By FY 1979, state revenue sharing and urban grants to Michigan cities, villages, and townships totaled $402.16 million. An additional $61.84 million in shared income tax receipts went to county governments. The 1979 county portion was 38% of the shared income taxes but is to be frozen at 35% in FY 1980. Table 15 shows the breakdown of shared revenues and urban grants by type of recipient government for 1979 with the method of allocation indicated.

## Current Issues

Governor Milliken and the 1979–80 session of the Michigan legislature are currently considering three changes in the state's system of revenue sharing:

1. To what extent should aid be further targeted on need?
2. Should there be a delay in the use of the 1980 population data in allocation formulas?
3. Should the formula be altered so that communities affected by property tax limitations, included in a successful tax limit initiative, will not lose state funds?[46]

### USE OF NEEDS FACTORS

Governor Milliken's desire to provide increased aid to Detroit has generally aroused strong opposition from state legislators. In addition to normal revenue sharing funds and the $31 million "equity payment" received by Detroit in 1979, the city also received $15.2 million of the $24 million urban grant appropriation. The urban grant program was only for 1979, prompting Governor Milliken to propose $40 million in new funds for FY 1981 to be distributed on the basis of demographic factors such as poverty levels, the number of elderly people in a community, declining population, and relative tax base growth. While the new aid formula would continue to target a large amount of aid to Detroit, over 300 large and small cities, villages, and townships were also expected to receive shares.

State Sen. Jerome Hart (D, Saginaw), chairman

**Table 15**

## DISTRIBUTION OF MICHIGAN STATE REVENUE SHARING AND URBAN GRANT AIDS FOR FY 1979, BY TYPE OF RECIPIENT LOCAL GOVERNMENT AND ALLOCATION FORMULA
**(in millions of dollars)**

| | Cities and Villages | Townships | Counties | Total | Formula |
|---|---|---|---|---|---|
| **State Revenue Sharing** | | | | | |
| Sales Tax | $148.082 | $70.328 | — | $218.411 | Population |
| Income Tax | 96.059 | 5.591 | $61.840 | 163.490 | Counties: Per Capita Others: Population × Relative Tax Effort |
| Intangibles Tax | 6.441 | 3.059 | — | 9.500 | Population |
| Single Business Tax | 38.095 | 2.005 | — | 40.100 | Population × Relative Tax Effort |
| General Fund* | 2.720 | 5.780 | — | 8.500 | 1975 Population, Relative Tax Burden |
| Urban Grants | 23.970 | .030 | — | 24.000 | Per Capita Income, Mill Rate, Assessment Factor |
| **TOTALS** | **$315.367** | **$86.793** | **$61.840** | **$464.001** | |

*Includes $5.0 million in special census allocation for communities with 15% growth and $3.5 million for communities which benefit from Relative Tax Burden provisions of the Revenue Sharing Act.
SOURCE: Michigan Department of Management and Budget, *Economic Report of the Governor, 1979*, Lansing, MI, Department of Management and Budget, 1979, p. 108.

of the Senate Appropriations Committee, has argued that Detroit already receives a disproportionate share of aids to the detriment of the state's other major cities such as Grand Rapids, Flint, and Saginaw. Hart said:

> I think we should help those cities that help themselves if we help anybody. .... I feel sorry for Detroit. I recognize it's the biggest city and they need the money but it's not fair to the rest of the state.[47]

## POPULATION DATA

Since the Revenue Sharing Act was passed in 1971, Michigan has used 1970 Census population data to allocate aids. In 1975 the legislature approved supplemental payments to communities that had grown 15% or more. However, many rapidly growing communities do not receive what they regard as their fair share of aid, either because they did not grow 15% by 1975 or because declining cities have not lost aid despite their loss in population.

As *Table 16* indicates six of Michigan's major cities, including Detroit, have lost population, with the total loss for the six approaching 13% for the period 1970–77. The rest of the state gained over 8% in population for the same period, with the major growth coming in Detroit's developing suburbs and in northern Michigan. It is expected that these trends have continued.

Governor Milliken proposed that the legislature delay the use of the 1980 Census population data

until October 1, 1980, to provide some time for declining communities to adjust to their reduced share.[48] At the time of this writing, the proposal had been introduced in the legislature and was waiting final action in the 1980 session.

## TAX LIMIT REPERCUSSIONS

The Proposition E constitutional amendment, passed in November 1978, also poses a current concern for the Michigan revenue sharing programs. Proposition E limits the growth in state revenues to increases in the consumer price index. Since the bulk of state revenue sharing is earmarked revenue, Proposition E potentially could limit the size of the revenue sharing account. However, the limitation leaves sufficient room for growth in state taxes so that forced cuts in sharing should not be a problem in the foreseeable future.

On the plus side, as far as local governments are concerned, Proposition E requires that the state not mandate new programs for local governments without full state financing and that the local aids share of the state budget not decline from 1979 levels. While the legislature and municipal officials differ on what constitutes a mandate and while the amendment had a chilling effect on supplemental appropriations to localities, it does effectively guarantee that state aid programs to localities and school districts will continue in one form or another. Implementing leg-islation for the "local share" section of the amendment was passed by the legislature and signed by the Governor Milliken during the 1979 legislative session.

Proposition E further requires that local property tax rates be rolled back if the growth in assessed value exceeds the rate of inflation. This could affect a locality's share of state revenue sharing because a relative reduction in its mill rate can reduce its state aid. Furthermore, the expected reduction of rates to less than one mill in the case of some townships would have the effect of eliminating relative tax effort aids to these communities. Governor Milliken has proposed that the legislature change the aid formula to protect aids to communities affected by the rollback provision of the amendment. Action on this measure is also expected in the 1980 legislative session.

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## FOOTNOTES

[1] James R. Donohue, "Local Government in Wisconsin," *Wisconsin Blue Book 1979–1980*, Madison Legislative Reference Bureau, Madison, WI, p. 214.
[2] Wisconsin Commission on State-Local Relations and Financing Policy, *The Final Report of the Commission on State-Local Relations and Financing Policy*, Madison, WI, 1977, p. 8–1.
[3] Wisconsin Task Force on Local Government Finance and Organization, *The Report of the Task Force on Local Government Finance and Organization*, Madison, WI, 1969, pp. vi–1,4.
[4] *Ibid.*, pp. vi–2–3.
[5] *Ibid.*, p. vii–1.

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*Table 16*

## POPULATION CHANGES FOR SELECTED MICHIGAN CITIES, 1970 TO 1977

|  | 1970 Population | 1977 Population | Percent Change |
|---|---|---|---|
| **Detroit** | 1,511,336 | 1,289,910 | −14.6% |
| **Grand Rapids** | 197,534 | 184,954 | −6.4 |
| **Flint** | 193,380 | 163,594 | −15.4 |
| **Lansing** | 131,638 | 127,128 | −3.5 |
| **Saginaw** | 91,820 | 82,162 | −10.5 |
| **Kalamazoo** | 85,661 | 79,077 | −7.7 |
| **TOTALS** | 2,211,369 | 1,926,825 | −12.8 |
| **Rest of State** | 6,663,714 | 7,202,175 | +8.1 |

SOURCE: U.S. Bureau of the Census and ACIR staff calculations.

[6] *Ibid.*, p. vii–1.
[7] Wisconsin Commission on State-Local Relations and Financing Policy, *op. cit.*, p. 19.
[8] Ibid., p. MR–8.
[9] "Summary of Major Items Approved and Vetoes Which Will Impact on Wisconsin Municipalities," *The Municipality*, Madison, WI, League of Wisconsin Municipalities, Vol. 74, No. 9, September 1979, p. 179.
[10] *Ibid.*, p. 181.
[11] *Ibid.*, p. 181.
[12] "The $8.8 Million Debate," *The Municipality*, Madison, WI, League of Wisconsin Municipalities, Vol. 74, No. 9, September 1979, p. 178.
[13] "Summary of Major Items Approved and Vetoed Which Will Impact on Wisconsin Municipalities," *op. cit.*, p. 181.
[14] Wisconsin Department of Revenue, Division of Local Fiscal Analysis, "Technical Supplement: Aidable Revenues Formula and Local Cost Impacts from Industry," Madison, WI, March 24, 1978 (internal department document).
[15] U.S. Department of Commerce, Bureau of the Census, *1967 Census of Governments: Volume 6, Topical Studies Number 4, State Payments to Local Governments*, Washington, DC, U.S. Government Printing Office, 1968, p. 15.
[16] *Ibid.*, p. 15.
[17] Minnesota Department of Revenue, *Property Taxes Levied in Minnesota: 1978 Assessments, Taxes Payable in 1979*, St. Paul, MN, 1979, p. 22.
[18] *Citizens League, New Formulas for Revenue Sharing in Minnesota*, Minneapolis, MN, Minneapolis Citizens League, 1970, pp. 47–48.
[19] *Ibid.*
[20] Minnesota Department of Taxation, Research and Planning Division, "Omnibus Tax Act Summary," St. Paul, MN, Minnesota Department of Taxation, 1971 (internal department document), pp. 6–7.
[21] Minnesota State Planning Agency, Office of Local and Urban Affairs, *Minneapolis-St. Paul Study, City Financial Conditions, Book II, Municipal Revenues, Intergovernmental Aids*, St. Paul, MN, Minnesota State Planning Agency, 1977, pp. 51–52.
[22] Minnesota Department of Revenue, *op. cit.*, pp. 8–12.
[23] *Ibid.*, p. 51.
[24] Minnesota State Planning Agency, *op. cit.*, p. 51.
[25] League of Minnesota Cities, *Minnesota Local Government Legislature Bulletin*, St. Paul, MN, League of Minnesota Cities, July 1975, p. 3.
[26] "State Aid Formula Changes," *Minnesota Cities*, St. Paul, MN, League of Minnesota Cities, Vol. 60, No. 12, December 1975, p. 5.
[27] Minnesota State Planning Agency, *op. cit.*, p. 52.
[28] For listing of reports see: Minnesota State Planning Agency, Office of Local and Urban Affairs, *Minneapolis-St. Paul Study: Final Summary Report*, St. Paul, MN, Minnesota State Planning Agency, June 1978, pp. 115–16.
[29] *Ibid.*, p. 5.
[30] Minneapolis Municipal Finance Commission, *Report of the Municipal Finance Commission to Mayor Albert J. Hofstede and the Minneapolis City Council*, Minneapolis, MN, Mayor's Budget Office, January 1978, p. X.
[31] Citizens League, *Local Discipline Not State Prohibitions: A Strategy for Public Expenditure Control in Minnesota*, Minneapolis, MN, Citizens League, 1978, pp. 11–12.
[32] *Ibid.*, pp. 11–12.
[33] Association of Metropolitan Municipalities, "Seminar—Levy Limits: How to Make the Best of a Bad Situation," St. Paul, MN, July 30, 1979 (photo copy of Association document), pp. 3–8.
[34] Commerce Clearing House (CCH), *Michigan Tax Reporter*, Vol. 1, Chicago, IL, CCH, Vol. 1, pp. 2110–11.
[35] "Tentative Policy Statements," *Michigan Municipal Review*, Lansing, MI, Michigan Municipal League, Vol. XLVI, No. 8, August 1973. p. 219.
[36] *Michigan State Constitution of 1908*, Article X, Section 23.
[37] *Michigan State Constitution of 1963*, Article IX, Section 10.
[38] *Ibid.*, Article VII, Section 21.
[39] "Tentative Policy Statement," *op. cit.*, p. 219.
[40] *Ibid.*, pp. 219–20.
[41] Robert L. Hegel, "State Shared Tax Returns Increase," *Michigan Municipal Review*, Lansing, MI, Michigan Municipal League, Vol. XLVI, No. 2, February 1973, p. 32.
[42] *Ibid.*, pp. 32–33.
[43] Robert L. Hegel, "State Shared Tax Returns Increase," *Michigan Municipal Review*, Lansing, MI, Michigan Municipal League, Vol. XLVII, No. 1, January 1974, p. 8.
[44] Shirley S. Smith, "Economic Recession Affects State-Shared Tax Returns," *Michigan Municipal Review*, Lansing, MI, Michigan Municipal League, Vol. XLIX, No. 2, February 1976, p. 31.
[45] Rochelle L. Stanfield, "Reving Up the Motor City," *National Journal*, Washington, DC, Government Research Corporation, Vol. 9, No. 50, December 12, 1977, p. 1970.
[46] Michigan Department of Management and Budget, *Economic Report of the Governor, 1979*, Lansing, MI, Michigan Department of Management and Budget, 1979, pp. 109–10.
[47] Robert H. Longstaff and Nancy E. Dunn, "Budget Stresses Aid to Detroit, Seeks Pay Cuts," *Grand Rapids Press*, January 30, 1979.
[48] Under a Michigan attorney general's opinion, payments are based on the Census population as of April 1, 1980. The Census population information will not be available until mid-1981. Communities receiving incorrect amounts of aid in 1980 will have adjustments made in the aids they receive in 1981. The delay in the use of the Census data should lessen the impact of the adjustments.

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# Sample Analysis Of Alternative General Sharing Formulas

It is clear that different formulas can produce different allocations, and an actual state and its localities can be used to compare and contrast the varying impact of different aid formulas.

Maryland has been chosen for this purpose because it is geographically small yet diverse, with central city, suburban, and rural populations. The primary providers of local services are 23 counties and the City of Baltimore. Maryland has no townships; cities outside of Baltimore provide services that basically supplement those services provided by the county. The existence of only 24 major local service providers simplifies calculation and analysis.

There is no intent in this analysis to propose changes in the present state-local fiscal relationship in Maryland. Maryland requires its localities to levy a local income tax equivalent to 20% to 50% of the state income tax liability of their residents. This has much the same effect as an origin-based revenue sharing system, where a share of state income tax receipts is distributed to localities.

The state also provides considerable aids which are technically categorized in nature but which could be considered general aids because few strings are attached. Much of this aid is distributed according to a "needs" basis, in proportion to local spending on particular services. In this manner the state compensates the City of Baltimore, which because of its low resident income, fares comparatively poorly in its level of local in-

come tax receipts. In 1979 Baltimore received 48% of the $77 million in categorical aids for police and general and regional library services.

*Table 17* shows that Baltimore also fares well in the state's shared revenue system due to its 50% share of highway user fees.

## REGIONS AND THEIR FISCAL CHARACTERISTICS

For purposes of analysis, Maryland has been divided into regions as shown in *Map 1*. These regions and their relevant characteristics are:

- The independent City of Baltimore—major central city, fiscally distressed, high property tax rate, low income tax receipts and property tax base.
- Baltimore's suburban counties—low to moderate spending, high income tax receipts, low property tax rate, moderate to high property tax base.
- Washington, DC's suburban Maryland counties—high spending, high income tax receipts, moderate property tax rate, high property tax base. (In 1970 Montgomery County

had the highest median family income of any large county in the United States.)

- Eastern and southern shores—rural with smaller cities, low spending, varied income tax recipts, low property tax rate, varied property tax base. (Calvert County has a nuclear power plant, Worcester and Talbot counties have valuable waterfront properties.)
- Western counties—generally rural with smaller cities, low spending, low to moderate income tax receipts, low property tax, moderate property tax base.

## FORMULA COMPARISONS: ORIGIN, POPULATION, TAX LEVIES, OR TAX RATES

The differing distributions under four basic alternative revenue sharing formulas in Maryland are presented in *Table 18*. Formula I represents the return of a share of state income taxes to the county of origin. Formula II distributes aid according to the 1977 Census Bureau estimate of population. Formula III allocates aid in proportion to total property tax levies—county, munic-

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Table 17

### STATE-LOCAL SHARED REVENUES IN MARYLAND, 1979
(in millions of dollars)

| Revenue Source | Total Shared | Baltimore City's Allocation | Percent | Basis for Allocation |
|---|---|---|---|---|
| Beer Tax | $  4,381 | $   935 | 21.3 | Origin |
| Liquor Tax | 5,712 | 1,288 | 22.5 | Origin |
| Tobacco Tax | 16,132 | 3,613 | 22.4 | Population and Hold Harmless |
| Corporate Fees | 883 | 223 | 25.3 | Origin |
| Franchise Tax | 3,574 | 800 | 22.4 | Origin |
| Highway User Fees | 117,075 | 58,544 | 50.0 | * |
| Horse Racing Revenue | 3,627 | 860 | 23.7 | Population |
| TOTALS | $151,384 | $66,263 | 43.8 | |

* 50% to Baltimore City, rest distributed to other counties and municipalities on basis of motor vehicle registration and road mileage.
SOURCE: Maryland Department of Fiscal Services, *Legislator's Guide to State and Local Fiscal Relationships*, Annapolis, MD, General Assembly, 1978, p. 75.

Map 1

MARYLAND COUNTIES, BY REGION

Legend:
- Baltimore City
- Suburban Baltimore
- Suburban Washington, D.C.
- Eastern and Southern Shore
- Western Maryland

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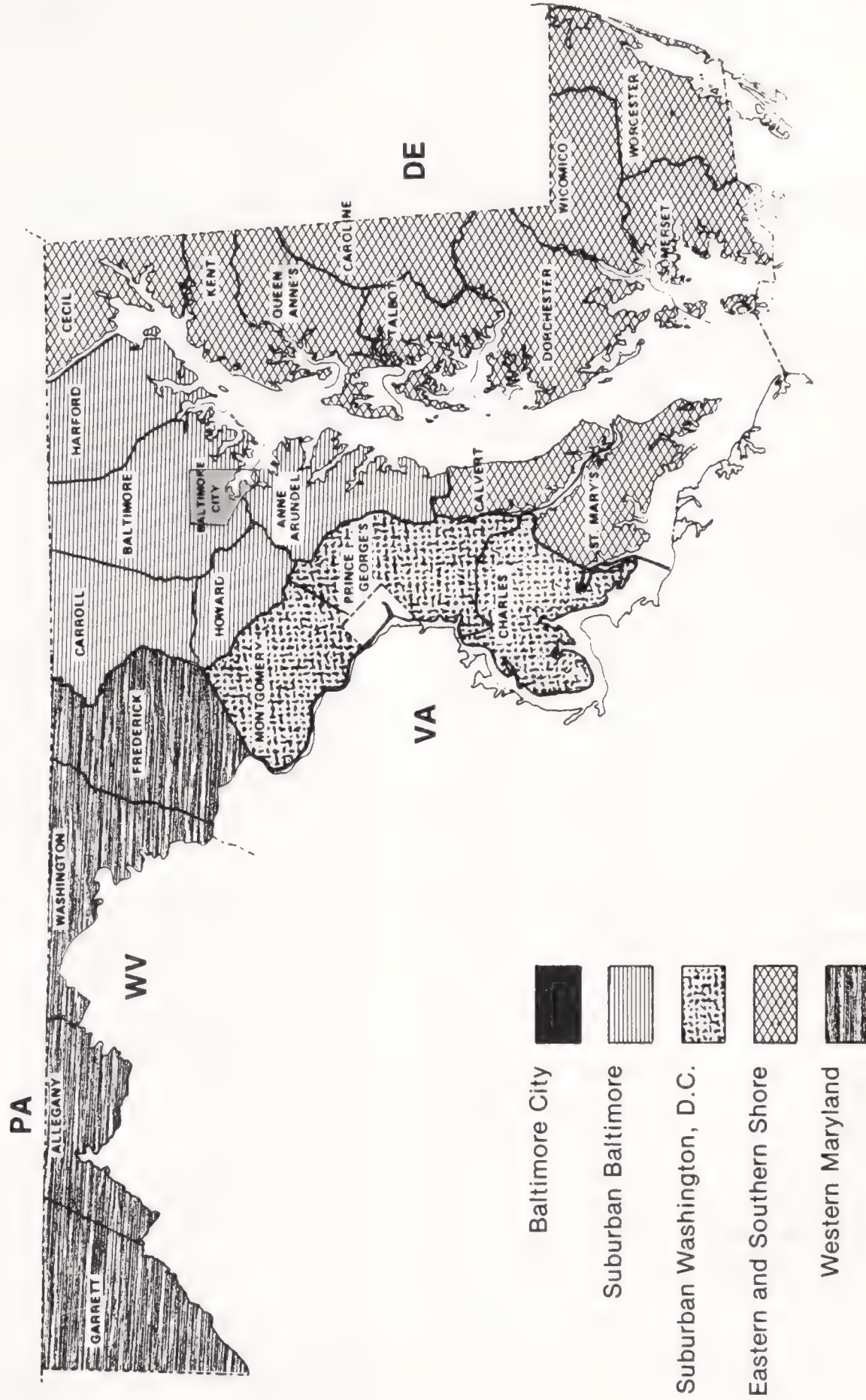
ipal, school—within each county area. Formula IV uses population multiplied by total property tax mill rate. Later a second set of comparisons is made among need-type formulas by specifically applying the Michigan, Minnesota, and Wisconsin formulas to local governments in Maryland.

Table 18

## THE DISTRIBUTIONAL IMPACT OF BASIC FORMULAS ON MARYLAND COUNTIES AND THE CITY OF BALTIMORE
### (amounts in percent)

| | Formula I Origin Share of Income Tax | Formula II Population | Formula III Property Tax Levy | Formula IV Population X Mill Rate | Most Favorable Formula | Least Favorable Formula |
|---|---|---|---|---|---|---|
| Allegheny | 1.343% | 1.958% | 1.226% | 1.744% | Population | Origin |
| Anne Arundel | 8.609 | 8.607 | 5.796 | 5.791 | Origin | Mill Rate |
| Baltimore City | 13.809 | 19.424 | 19.687 | 32.280 | Mill Rate | Origin |
| Baltimore County | 18.214 | 15.504 | 13.755 | 12.460 | Origin | Mill Rate |
| Calvert | .601 | .725 | 1.593 | .448 | Levy | Mill Rate |
| Caroline | .360 | .531 | .276 | .425 | Population | Origin |
| Carroll | 2.100 | 2.135 | 1.583 | 1.443 | Population | Mill Rate |
| Cecil | .899 | 1.346 | .839 | 1.027 | Population | Levy |
| Charles | 1.319 | 1.568 | 1.340 | .944 | Population | Mill Rate |
| Dorchester | .480 | .737 | .556 | .633 | Population | Origin |
| Frederick | 2.281 | 2.498 | 2.039 | 1.892 | Population | Mill Rate |
| Garrett | .326 | .620 | .458 | .488 | Population | Origin |
| Harford | 2.981 | 3.470 | 2.510 | 3.233 | Population | Levy |
| Howard | 3.447 | 2.677 | 2.954 | 1.882 | Origin | Mill Rate |
| Kent | .276 | .400 | .303 | .275 | Population | Mill Rate |
| Montgomery | 21.104 | 13.811 | 20.731 | 12.868 | Origin | Mill Rate |
| Prince George's | 15.832 | 16.370 | 18.406 | 17.125 | Levy | Origin |
| Queen Anne's | .457 | .544 | .290 | .237 | Population | Mill Rate |
| St. Mary's | .890 | 1.292 | .660 | .757 | Population | Levy |
| Somerset | .220 | .480 | .201 | .280 | Population | Levy |
| Talbot | .657 | .626 | .515 | .350 | Origin | Mill Rate |
| Washington | 2.162 | 2.626 | 1.899 | 2.089 | Population | Levy |
| Wicomico | 1.121 | 1.458 | 1.016 | .937 | Population | Mill Rate |
| Worcester | .514 | .592 | 1.364 | .434 | Levy | Mill Rate |
| Baltimore City | 13.809 | 19.424 | 19.687 | 32.280 | Mill Rate | Origin |
| Baltimore Suburbs | 35.351 | 32.393 | 26.598 | 24.809 | Origin | Mill Rate |
| Washington Suburbs | 38.255 | 31.749 | 40.477 | 30.937 | Levy | Mill Rate |
| Eastern and Southern Shore | 6.475 | 8.731 | 7.613 | 5.803 | Population | Mill Rate |
| Western Maryland | 6.112 | 7.702 | 5.622 | 6.173 | Population | Origin |

SOURCE: ACIR staff calculations based on data from Maryland Department of Fiscal Services. Division of Fiscal Research, *Local Government Finances in Maryland for the Fiscal Year Ended June 30, 1978*, Annapolis, MD, Department of Fiscal Services, 1979.

Those counties that benefit the most from the origin formula are, as expected, the higher income counties in the state. These include Montgomery County, the state's highest income county, as well as three of the five suburban Baltimore counties plus the eastern shore county of Talbot.

The counties whose most favorable formula is one based on population are the counties whose moderate or low income, wealth, and low taxes make the other formulas unfavorable. This category includes the bulk of the counties in western Maryland and those on the southern and eastern shores, with a few exceptions.

The third formula distributed revenue in proportion to the local property tax levy. The beneficiaries are Calvert and Worcester of the eastern and southern shore, and Prince George's County next to Washington, DC. Calvert and Worcester have the state's highest per capita property tax base, both having roughly three times the state average of per capita valuation. In Calvert this is due primarily to the presence of the nuclear power plant, while Worcester's property wealth is due to extensive development along the state's only Atlantic beachfront. Both counties have opted for the minimum level of local income tax rate allowable under state law, effectively shifting taxes to the owners of the power plant and the beachfront property. The property tax levy in these counties, therefore, is comparatively high.

The third county that would benefit from the property tax levy formula is Prince George's. Its large property tax levy is partly due to the comparatively small amount of money that it raises through the piggyback local income tax.

The principal gainer from a formula that distributed revenue sharing according to population multiplied by property tax mill rate would be the City of Baltimore. The city would receive nearly one-third of all funds distributed in this manner, considerably more than it would receive under the origin, population, or levy approaches.

Baltimore's advantage under the mill rate formula stems not so much from a high level of property taxes but rather from the small tax base and lack of alternative revenues. Baltimore's per capita property tax base is the smallest in the state and its piggyback income tax receipts are comparatively low despite levying the maximum rate.

Viewed regionally the areas of the state would find it hard to agree on a single formula. No two regions are most advantaged and most disadvantaged by the same set of formulas. Baltimore City's great advantage in the mill rate formula translates into a great disadvantage for the other areas of the state. Formulas that would favor suburban areas would not be helpful to Baltimore or the rural areas of the state. Similarly, formulas advantageous to rural areas are disadvantageous to urban areas. When dividing up a pie, relatively more for one recipient means relatively less for another recipient.

## MICHIGAN, MINNESOTA, AND WISCONSIN FORMULAS

Wisconsin, Minnesota, and Michigan all share at least a portion of the funds for local governments on the basis of their revenue and expenditure needs. All three incorporate a measure of tax capacity and a measure of local tax effort. Minnesota distributes the vast majority of its revenue sharing in this manner, while Wisconsin distributes over half of its revenue sharing in this fashion with the aidable revenues formula. Michigan likewise distributes part of its revenue sharing under effort and capacity factors using the tax effort formula.

*Table 19* gives estimates of the distributional impact of the Wisconsin, Minnesota, and Michigan effort and capacity formulas if they were used in Maryland. *Table 19* also shows how the distribution for each formula would be affected if minimums were imposed such that no county could receive an aid share equal to less than one-half of the individual county's share of state population. (If a county had 10% of state population, it would receive at least 5% of total shared revenues.) Minimums were allowed because all three states guarantee minimum aid levels based on the previous year's allocation.

The three midwestern formulas were simplified and applied in the following fashion:

### Wisconsin "Aidable Revenues"

$$\left( 1 - \frac{\text{Locality's Assessed Valuation}}{(\$15,000) \times (\text{Locality's Population})} \right) \times \left( \begin{array}{c} \text{All Locally} \\ \text{Raised} \\ \text{Revenues} \end{array} \right)$$

### Minnesota

$$\left( \begin{array}{c} \text{Total Local Property and} \\ \text{Income Tax Revenues} \end{array} \right) - \left( \begin{array}{c} .03 \times \text{Local} \\ \text{Assessed Valuation} \end{array} \right)$$

Table 19

## THE DISTRIBUTIONAL IMPACT OF ELEMENTS OF FORMULAS IN USE IN WISCONSIN, MINNESOTA, AND MICHIGAN ON MARYLAND COUNTIES AND THE CITY OF BALTIMORE
### (amounts in percent)

| | Wisconsin Aidable Revenues | Wisconsin With Minimums* | Minnesota | Minnesota With Minimums* | Michigan Relative Tax Effort | Michigan With Minimums* |
|---|---|---|---|---|---|---|
| Allegheny | 1.791% | 1.779% | 1.218% | 1.172% | 1.673% | 1.672% |
| Anne Arundel | 8.012 | 7.959 | 4.234 | 4.304 | 7.342 | 7.336 |
| Baltimore City | 29.722 | 29.526 | 29.507 | 28.395 | 30.567 | 30.543 |
| Baltimore County | 14.384 | 14.289 | 13.443 | 12.936 | 13.761 | 13.750 |
| Calvert | 0.0 | 0.363 | 0.0 | 0.363 | 0.316 | 0.363 |
| Caroline | 0.369 | 0.367 | 0.264 | 0.266 | 0.426 | 0.426 |
| Carroll | 1.566 | 1.556 | 0.979 | 1.068 | 1.540 | 1.539 |
| Cecil | 0.961 | 0.955 | 0.576 | 0.673 | 0.991 | 0.990 |
| Charles | 0.870 | 0.864 | 0.113 | 0.784 | 0.913 | 0.912 |
| Dorchester | 0.618 | 0.614 | 0.420 | 0.404 | 0.563 | 0.563 |
| Frederick | 2.082 | 2.068 | 1.441 | 1.387 | 1.883 | 1.882 |
| Garrett | 0.395 | 0.392 | 0.139 | 0.310 | 0.389 | 0.389 |
| Harford | 3.214 | 3.193 | 2.862 | 2.754 | 3.210 | 3.208 |
| Howard | 1.656 | 1.645 | 1.727 | 1.662 | 2.159 | 2.157 |
| Kent | 0.273 | 0.271 | 0.107 | 0.200 | 0.256 | 0.256 |
| Montgomery | 11.099 | 11.026 | 21.014 | 20.222 | 13.097 | 13.087 |
| Prince George's | 17.499 | 17.384 | 19.792 | 19.046 | 15.980 | 15.968 |
| Queen Anne's | 0.307 | 0.305 | 0.0 | 0.272 | 0.244 | 0.272 |
| St. Mary's | 0.811 | 0.806 | 0.191 | 0.646 | 0.827 | 0.826 |
| Somerset | 0.260 | 0.258 | 0.016 | 0.240 | 0.270 | 0.270 |
| Talbot | 0.520 | 0.517 | 0.0 | 0.313 | 0.315 | 0.315 |
| Washington | 2.602 | 2.585 | 1.620 | 1.559 | 2.050 | 2.050 |
| Wicomico | 0.990 | 0.983 | 0.336 | 0.729 | 0.894 | 0.893 |
| Worcester | 0.0 | 0.296 | 0.0 | 0.296 | 0.336 | 0.336 |
| | | | | | | |
| Baltimore City | 29.722 | 29.526 | 29.507 | 28.395 | 30.567 | 30.543 |
| Baltimore Suburbs | 28.832 | 28.642 | 23.245 | 22.724 | 28.012 | 27.990 |
| Washington Suburbs | 29.468 | 29.274 | 40.919 | 40.052 | 29.990 | 29.967 |
| Eastern & Southern Shore | 5.109 | 5.735 | 1.910 | 4.402 | 5.438 | 5.510 |
| Western Maryland | 6.870 | 6.824 | 4.418 | 4.428 | 5.995 | 5.993 |

* Minimums defined as one-half the per capita share.
SOURCE: ACIR staff calculations based on data from Maryland Deparment of Fiscal Services, Division of Fiscal Research, *Local Government Finances in Maryland for the Fiscal Year Ended June 30, 1978*, Annapolis, MD, Department of Fiscal Services, 1979.

## Michigan "Relative Tax Effort"

$$(\text{Locality Population}) \times \left( \frac{\dfrac{\text{All Local Taxes}}{\text{Local Assessed Valuation}}}{\dfrac{\text{Statewide Local Taxes}}{\text{Statewide Assessed Valuation}}} \right)$$

Since local governments in Maryland levy income taxes, unlike local governments in Wisconsin and Minnesota, income tax receipts have been treated as property taxes in the formulas. Maryland also differs from the midwestern states in that there are no independent school districts. Instead schools are a responsibility of the 23 county governments and the City of Baltimore. Therefore school revenues have not been separated out from county and municipal general purpose revenues.

The differences resulting from the three formulas reflect how fiscal capacity and revenue effort are calculated in the three states. Under Wisconsin's aidable revenues formula, the community's assessed valuation (as equalized) is compared to a state set standard equal to roughly twice the statewide per capita average. Since Maryland's per capita assessed valuation equaled $7,550 in FY 1978, a per capita valuation of $15,000 has been used in the calculation. Under the Wisconsin formula, no community with a per capita valuation above the state-set amount receives aidable revenue aids. Wisconsin counts nearly all locally raised revenue in the determination of revenue effort. For this reason all local revenues have been used in the Maryland calculation.

Minnesota bases its shared revenue allocations on the portion of property taxes due to a rate over and above a state-determined equalized tax rate. In Maryland a 3% total tax rate, which includes all local property and income taxes as a percent of assessed valuation, is roughly equivalent to the ten equalized mills for municipal purposes used in the Minnesota formula. Most Maryland counties have an effective property and income tax rate equal to between 3% and 5% of assessed valuation. Baltimore City's effective tax rate is 7.7% while four southern and eastern shore counties have effective tax rates below 3%. Aids are made in proportion to property and income taxes above what a 3% property tax would raise.

Michigan calculates relative tax effort aids by adding all local municipal tax revenues (property, income, and excise) and dividing this number by local equalized assessed valuation. This tax rate is then indexed to the state average and multiplied by local population. The Maryland calculation differs only in that it includes all local tax revenues rather than just the municipal share.

Despite the similarity in the theory behind the formulas, the allocations do sometimes vary considerably. Montgomery County would receive roughly 11% of the statewide allocation under the Wisconsin formula but 20% to 21% under the Minnesota formula. The Michigan formula yields results similar to the Wisconsin formula with Montgomery County receiving 13%. Prince George's County, like its neighbor Montgomery, also fares best under the Minnesota formula. The advantage to these counties under the Minnesota formula comes mainly at the expense of Baltimore's suburbs and eastern and southern Maryland. Suburban Baltimore and western Maryland do best under the Wisconsin formula. The eastern and southern shores would choose the Michigan formula of the three. Interestingly, Baltimore City receives roughly 30% under all three formulas.

The reason why the counties in suburban Washington, DC, and suburban Baltimore have different allocations is that the former have both more property tax wealth and higher revenue effort relative to their wealth than do the latter. All three formulas reward low tax base and high revenue effort. The Minnesota formula, with adjustments that have been made, emphasizes high revenue effort to a greater extent than do the Wisconsin and Michigan formulas, which emphasize fiscal capacity to a greater degree.

Both the Minnesota and Wisconsin approaches allow for more or less "targeting" through the adjustment of the state-set standard mill rate (in the case of Minnesota) and the state-set standard per capita valuation. Increasing the mill rate or decreasing the per capita valuation standards would increase aids going to high effort/low capacity communities. If the mill rate standard was raised sufficiently or the per capita valuation lowered sufficiently, the City of Baltimore could receive 100% of aids under the Minnesota or Wisconsin formulas (which would make formulas unnecessary).

# Alternative Aid Targeting And Tax Base Sharing

$T$he Wisconsin, Minnesota, and Michigan revenue sharing systems, which are discussed in *Chapter III*, not only provide support to all local governments, but also "target" relatively more aid to communities with the greatest need, as evidenced by high expenditures and/or low property valuations. High taxes and low valuations, as indicated in a previous section, are thought not only to be indicators of financial need but also as being symptomatic of the social and economic problems and disadvatages some localities face. A particlar emphasis has been placed on maintaining the financial viability of Milwaukee, Minneapolis, St. Paul, and Detroit.

Many states with state-local revenue sharing systems do not attempt both major sharing and targeting. In some of the western and Great Plains states, which are less urbanized and more governmentally and socially homongeneous, there may be few communities that need targeting. Rather in these states origin- and per capita-based formulas are often used.

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## TARGETED AID PROGRAMS

Two states in particular, New Jersey and Connecticut, represent the reverse of the situation existing in the Great Plains and the west. Both states are highly suburbanized and socially heterogeneous with a high statewide level of personal income. Certain central cities in each of these states, however, do not share the relative statewide level

of affluence. It is generally agreed that Newark, Jersey City, Paterson, Trenton, and Camden face more severe financial, economic, and social problems than do the suburban and rural areas of New Jersey. Similarly, Hartford, New Haven, Bridgeport, and Waterbury are acknowledged to have a disproportionate share of the problems facing local government in Connecticut.

In response to the special conditions in New Jersey and Connecticut, the state governments have, in the past ten years, experimented with various aid programs and formulas to target general aid only to the more hard-pressed localities. In Connecticut the principal local government aid program is targeted, but it has been supplemented in some years with property tax relief aid distributed on a per capita basis. New Jersey has a per capita aid program that has been supplemented with one or more highly targeted programs.

## Connecticut Program

The Connecticut urban aid program targeted nearly $24 million to Connecticut cities and towns in FY 1979, up from $11 million in FY 1978. In 1978 aid was allocated:

- 10% according to population,
- 50% divided among communities with population densities exceeding the state density, according to a local density-weighted population formula, and
- 40% in proportion to the number of public housing units in a community.

The formula for FY 1979 was further adjusted; the amount of aid determined by population, density, and public housing was multiplied by the ratio of state per capita income to local per capita income, with aid prorated according to the result. The effect of this modification was to target more aid to localities with below average per capita income. Hold harmless provisions prevented low need towns from suffering a loss in aids between the two years.[1]

## New Jersey Program

New Jersey's targeted revenue sharing, also called urban aid, originated in FY 1970 with an appropriation of $12 million. The program has grown to $39 million in FY 1979. The funds are distributed according to an equalizing formula to all municipalities in the state meeting all of the following five criteria:

- Population of at least 15,000, or population density of 10,000 per square mile.
- More than 350 school students in the Aid for Dependent Children program.
- An equalized tax rate above the state average equalized tax rate.
- An equalized valuation per capita less than the state equalized valuation per capita.
- The existence of publicly financed housing.[2]

The targeted nature of New Jersey urban aid is best illustrated by comparison with the state's per capita revenue sharing program. The revenue sharing program distributes aid to all localities having a total effective property tax rate of at least 1%. In 1978 eligible recipients of New Jersey revenue sharing numbered 559 out of state's 567 cities, boroughs, and townships. The eligible number of recipient local governments of urban aid for 1979 was only 31.[3]

The logic behind the urban aid programs in both Connecticut and New Jersey is that considerable equalization can be achieved with comparatively little money if the formulas used to distribute the funds assure that "well-off" communities receive little or no aid. It is not sufficient that the formulas used include criteria or data elements favorable to needy communities; in addition, if substantial equalization is to take place, the criteria for eligibility or data elements must each, or in combination, be virtually unique to the municipalities to receive targeted aid.

## METROPOLITAN TAX BASE SHARING

State-local revenue sharing is the transfer of state resources to localities. An alternative approach to deal only and more directly with metropolitan disparities is to transfer tax base resources from "wealthy" to "poor" communities. Minnesota, in addition to its state-local sharing, also has such a tax base sharing system in the seven-county Minneapolis-St. Paul metropolitan area.

Under Minnesota's fiscal disparities act passed in 1971, localities in the metropolitan area con-

tribute 40% of post 1971 growth in commercial and industrial valuation. Tax revenue from this tax base is then redistributed back to the localities according to an index of population times the inverse of local relative per capita property valuation times two.

Property valuation does not actually shift from one taxing jurisdiction to another. Instead, all commercial-industrial property owners pay taxes that are partially determined by both their host locality's tax rate and a metropolitan average tax rate. The revenue derived from the metropolitan tax rate is then apportioned to localities according to the distribution formula.

Since the fiscal disparities law pertains to only a portion of the local property tax base—40% of the growth in commercial industrial valuation since 1971—the redistribution of tax base and tax revenue has been comparatively small. With inflation and the passing of time, however, the growth portion of commercial-industrial valuation will loom larger and further lessen disparities in property tax wealth. Futhermore, since the portion of commercial-industrial valuation taxed at the metropolitan tax rate is determined by the growth portion of the total commercial-industrial

tax base, the difference among localities in the effective rate of taxation of commercial-industrial properties is declining, lessening the incentive for location in low tax islands in the metropolitan area. In addition to reserving an innovative and controversial technique only to the area of the state expressing the most concern, the concept of sharing tax base may appear simpler in concept and a more straightforward remedy to taxpayers than being subject to higher state taxes in order to finance a redistributive state aid system. In practice, the system is, of course, complex, limited in ability to counteract past differences in accumulated financing capacity, and it does not readily extend to solving very wide-ranging geographic and statewide problems of local financial inequity.

## FOOTNOTES

[1] Connecticut General Statutes, Sections 2-123d and 8-159a.
[2] New Jersey Department of Community Affairs, *A Strategy for the Conservation and Revitalization of New Jersey Communities: State Strategy Activities*, Trenton, NJ, Department of Community Affairs, 1979, pp.1–2 (discussion draft prepared for the U.S. Department of Housing and Urban Development).
[3] *Ibid.*, p. 2.

# Conclusions, Caveats, And Diversity Among The States

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State aid in general and state-local revenue sharing in particular have been growing parts of the state-local fiscal relationship. The aversion of homeowners to property tax increases; the legal, political, and practical constraints on local own source revenues; and the slowdown projected for federal aid all suggest that localities must continue to look to their state government for some fiscal relief.

The preceding chapters illustrate that how state revenues are shared can be as important as how much state revenues are shared. The case studies of Wisconsin, Minnesota, and Michigan show an initial theme of wrangling between state and local officials on the size of the revenue sharing pie with a later emphasis placed on how to slice the pie.

State-local revenue sharing can be, and is, used to solve or ameliorate many problems in the state-local fiscal relationship. Revenue sharing lessens reliance on the unpopular property tax and sharing can be used to compensate hard-pressed communities for a number of fiscal inequities. Finally, state-local revenue sharing provides for a larger amount of growth and flexibility in local finances than does the property tax.

## CAVEATS

There are, however, certain pitfalls that state and local officials should be aware of before they expand and restructure their revenue sharing.

These pitfalls can be summarized as local dependence, lack of accountability, and loss of local control.

As localities become more dependent on the state government for their aid, they also become more closely tied to the financial fortunes of the state. As the case studies further illustrate, one recent development in state general revenue sharing has been the tying of such aid to the growth (and decline) of state revenues. Thus, aid to local government is deliberately locked into the state budget picture. The financial difficulties of New York State which earmarks aid, for example, have caused state officials to propose cutbacks in state-local revenue sharing. While many of the states outside the northeast had budget surpluses, fiscal prosperity is not guaranteed. Revenue sharing at the federal level was originally proposed in part as a way of dispensing expected federal surpluses. Continued federal deficits have caused the proposed elimination of revenue sharing to the states. Further, state government and its tax sources are not immune to popular initiatives as Proposition 13 demonstrated. In a time of fiscal crunch, intergovernmental aids, particularly general purpose intergovernmental aids, are often the easiest budget cuts.

Nor is this experience limited to the United States. Localities in the United Kingdom are contemplating dramatic tax increases in the wake of reductions in general aid by Parliament.

As the state government's financial involvement in local affairs increases, there is an inevitable blurring of accountability for the condition of local finances. Local officials may blame the inadequacy of state aid for tax increases that are actually the result of poor financial planning. On the other hand, state officials may use general state aids as fiscal backing for imposing more mandates on local governments, or as a way of sidestepping basic reforms in the structure and financing of local governments, particularly in metropolitan areas.

The blurring of accountability, or at least the fear of it, may lead to the third pitfall of state revenue sharing: increasing state control of local affairs. Just as there are no free lunches, there is no such thing as money without strings. The string most commonly attached to state-local revenue sharing is that the money be used for the replacement of local property tax revenues rather than for other purposes. Sometimes this string is implied or clarified after the fact. The locality that

uses its revenue sharing to pay for new services, higher salaries, or increased pension benefits, or that merely fails to live up to the tax cut expectations of the state legislature, is likely to have its finances brought under the scrutiny of the state.

Despite these caveats, state-local revenue sharing can be, and usually is, good policy. If state and local officials are explicit and realistic in stating the purpose and conditions under which revenue sharing is provided and accepted, state revenue sharing can broaden the local revenue base, counteract great inequality among localities' financing abilities, and forge a more responsive, less regressive state-local revenue structure.

It should also be remembered that state-local revenue sharing is not the only means of achieving local financial diversity, equity, and growth. Other strategies, in combination with each other or with sharing, may achieve these financial goals while putting more emphasis on maintaining local fiscal and political independence and accountability. *Figure 1* compares revenue sharing with alternative strategies to meet some of the purposes of enhancing local fiscal capacity.

State-local revenue sharing, as indicated, may be the best way of meeting the three financial goals listed, although independence and accountability may be sacrificed to a certain degree. Allowing local governments to use other revenue sources, such as a local income or sales tax, would provide for a greater degree of local control and independence, but it may increase the inequality in taxing ability between rich and poor communities. Nonproperty taxes may not be practical for very small local governments, nor may they be acceptable in localities where taxpayers fear an increase in overall taxes rather than property tax relief. In most states, new local taxes would introduce new complexity and difficulties into tax administration, whereas revenue sharing programs are generally established.

Substate regional governmental entities and regional tax base sharing could allow for more local fiscal independence than would state sharing, but would not by itself lessen property tax burdens. Moreover, municipalities sometimes argue that regional taxation threatens their local automony. Tax base sharing addresses the problem of local financing inequality, but is a regional rather than statewide tool and provides no new local revenue. Categorical state aids, state assumption of local responsibilities, and circuit-breaker-type payments for homeowners, to varying degrees, would

## Figure 1

### ALTERNATIVES TO STATE-LOCAL REVENUE SHARING AND THEIR LIKELY RESULTS

| Given This Strategy | Local Financial Goals: Are These Achieved? | | | Independence and Accountability Goals: Are These Maintained? | | |
| --- | --- | --- | --- | --- | --- | --- |
| | Property Tax Relief | Financing Equity Among Localities | Local Revenue Diversification & Growth | Local Fiscal Independence | Local Accountability for Use of Tax Dollars | Local Political Independence From State |
| State-Local Sharing | Yes | Yes | Yes | No | No | ? |
| Local Revenue Options | Yes | No | Yes | Yes | Yes | Yes |
| Substate Regional Government | ? | Yes | ? | Yes | ? | ? |
| Tax Base Sharing | No | Yes | No | Yes | ? | Yes |
| Categorical State Aid | Yes | ? | Yes | No | No | No |
| State Assumption of Local Functions | Yes | ? | No | Yes | No | No |
| Circuit Breaker | Yes | No | No | Yes | ? | Yes |

also be alternatives to revenue sharing, but would not make a positive contribution to preserving local autonomy or accountability, nor be fully successful in dealing on behalf of all taxpayers with the problem of local financing inequality.

A state that does not object to allowing localities additional revenue raising authority could retarget revenue sharing or employ tax base sharing to correct for equity shortcomings of the local revenue diversification. The "spreading effect" common to many revenue sharing programs could be avoided if the tax relief goal were met by local revenue diversification. However, this strategy would not be simple nor might it be feasible, even if a revenue sharing program with sufficient funding was already in place.

## DIVERSITY AMONG THE STATES

The 49 states that share revenues with their local governments vary considerably in the amount of revenue shared and the method of allocation. It should not be assumed that all states without extensive need-based sharing should have it. Rather, the need for it depends on factors such as property tax levels, the degree to which a local government must finance state-local expenditures, and the level of disparity between the tax base of wealthy or low need communities and those in opposite circumstances. Table 20 ranks the 50 states according to each of these three criteria.

These criteria can be used to suggest those states for which expanded and need-based revenue sharing may be appropriate. The first consideration is the level of property taxes. Below average property taxes are likely to mean that local financing disparities are not as serious as when property tax levels are high, and that it may be difficult to persuade the voters to accept higher state taxes for sake of local financial assistance. Exceptions to this rule of thumb can be made for the state in which property taxes are low but in which local income or sales tax base inequalities

are a concern because of extensive local reliance on these tax bases.

The level of local financing of state-local services is the second criterion. If the bulk of state-local services is already financed at the state level, either because of high state aid or state-level service centralization, there may be less need for state action, other than reconsideration of its sharing technique if sharing is already important.

Of the 25 states with property tax burdens above the median, 14 are states where the local responsibility for financing state-local services also exceeds the median. These are displayed graphically in *Figure 2*.

Of these 14 high property tax, high local responsibility states, eight are states with metropolitan fiscal disparities above the median level. These eight are Massachusetts, New York, New

*Table 20*

## STATE RANKINGS

| Property Tax Burden[1] | | Local Share[2] of State-Local Own Source Revenues | | Metropolitan[3] Fiscal Disparities Index | |
|---|---|---|---|---|---|
| 1 Massachusetts | 181 | New York | 54.8% | Delaware | 68.9% |
| 2 New York | 174 | New Hampshire | 53.7 | Michigan | 57.5 |
| 3 New Jersey | 146 | Nebraska | 53.1 | Oregon | 57.5 |
| 4 New Hampshire | 140 | New Jersey | 51.3 | Massachusetts | 52.6 |
| 5 Rhode Island | 133 | Nevada | 50.7 | Maryland | 51.7 |
| 6 South Dakota | 129 | Colorado | 48.9 | Pennsylvania | 47.4 |
| 7 California | 129 | Kansas | 48.9 | Missouri | 46.8 |
| 8 Nebraska | 128 | Montana | 48.9 | Georgia | 44.6 |
| 9 Connecticut | 126 | Missouri | 48.8 | South Carolina | 38.4 |
| 10 Oregon | 126 | Florida | 48.6 | Ohio | 37.1 |
| 11 Arizona | 125 | California | 48.5 | Alabama | 33.6 |
| 12 Vermont | 125 | Ohio | 48.5 | New Jersey | 33.1 |
| 13 Montana | 116 | South Dakota | 47.6 | New York | 33.0 |
| 14 Michigan | 113 | Massachusetts | 47.5 | West Virginia | 32.7 |
| 15 Colorado | 105 | Georgia | 46.9 | Utah | 32.6 |
| 16 Kansas | 103 | Illinois | 46.7 | Washington | 31.9 |
| 17 Wisconsin | 101 | Oregon | 46.4 | Illinois | 31.6 |
| 18 Illinois | 99 | Texas | 45.5 | Minnesota | 30.1 |
| 19 Maine | 97 | Connecticut | 45.3 | Connecticut | 30.0 |
| 20 Maryland | 94 | Tennessee | 44.5 | Florida | 29.7 |
| 21 Wyoming | 93 | Wyoming | 44.5 | Colorado | 27.9 |
| 22 Minnesota | 92 | Iowa | 43.9 | California | 23.5 |
| 23 Iowa | 90 | Arizona | 42.6 | Kentucky | 22.9 |
| 24 Indiana | 86 | Maryland | 42.3 | Wisconsin | 17.3 |
| 25 Alaska | 86 | Michigan | 42.2 | North Carolina | 15.9 |
| 26 North Dakota | 85 | Pennsylvania | 41.7 | Oklahoma | 13.8 |
| 27 Georgia | 82 | Virginia | 39.7 | Indiana | 12.9 |
| 28 Ohio | 81 | Washington | 39.5 | Tennessee | 12.5 |
| 29 Texas | 81 | Indiana | 39.1 | New Hampshire | 8.7 |
| 30 Washington | 80 | Idaho | 38.8 | Arkansas | 8.6 |

Jersey, California, Oregon, Connecticut, Michigan, and Maryland. As of 1977, therefore, these states were prime candidates for higher and new need-based revenue sharing. Increased state assumption of welfare or school costs may be other policy options, but authorization of new local taxing authority is likely to aggravate rather than counteract the measured metropolitan disparities.

The extent of metropolitan fiscal disparities has been measured by the technique explained in the notes for *Table 20*. The measures reflect differences between central cities and surrounding municipalities in metropolitan areas. The differences are measured through the federal general revenue sharing formula which is sensitive to variation in the level of per capita taxes and personal income. The measures do not directly reflect differences in property tax base per capita nor differences

*Table 20 (continued)*

## STATE RANKINGS

| Property Tax Burden[1] | | Local Share[2] of State-Local Own Source Revenues | | Metropolitan[3] Fiscal Disparities Index | |
|---|---|---|---|---|---|
| 31 Idaho | 79 | Vermont | 38.6 | Maine | 8.3 |
| 32 Nevada | 79 | Minnesota | 37.9 | Louisiana | 8.1 |
| 33 Missouri | 75 | Utah | 37.5 | Virginia | 8.1 |
| 34 Utah | 73 | Wisconsin | 37.2 | Mississippi | 3.7 |
| 35 Virginia | 73 | Rhode Island | 37.0 | Texas | 1.4 |
| 36 Florida | 71 | Alabama | 35.4 | Vermont | 0.0 |
| 37 Pennsylvania | 68 | Maine | 35.1 | Rhode Island | 0.0 |
| 38 Tennessee | 64 | Oklahoma | 34.9 | Iowa | 0.0 |
| 39 Mississippi | 64 | Mississippi | 34.4 | North Dakota | 0.0 |
| 40 South Carolina | 58 | Arkansas | 34.4 | South Dakota | 0.0 |
| 41 North Carolina | 52 | North Dakota | 34.3 | Nebraska | 0.0 |
| 42 Arkansas | 52 | Louisiana | 34.2 | Kansas | 0.0 |
| 43 Oklahoma | 50 | South Carolina | 34.0 | New Mexico | 0.0 |
| 44 Hawaii | 49 | North Carolina | 33.1 | Arizona | 0.0 |
| 45 Kentucky | 48 | Alaska | 28.2 | Montana | 0.0 |
| 46 New Mexico | 45 | West Virginia | 27.8 | Idaho | 0.0 |
| 47 West Virginia | 43 | Kentucky | 26.3 | Wyoming | 0.0 |
| 48 Louisiana | 37 | Delaware | 22.9 | Nevada | 0.0 |
| 49 Delaware | 36 | New Mexico | 20.3 | Alaska | 0.0 |
| 50 Alabama | 30 | Hawaii | 19.8 | Hawaii | 0.0 |

[1] 1977 property tax effort relative to ability as measured by Kent Halstead and Kent Weldon, *Tax Wealth in the Fifty States: 1977 Supplement*, Washington, DC, National Institute of Education, 1977, pp. 162–63.

[2] Percent of 1978 state-local own source revenue raised at the local level. ACIR staff calculation based on U.S. Bureau of the Census, *Governmental Finances in 1977–78*, Washington, DC, U.S. Government Printing Office, 1980, pp.18–26.

[3] Index calculated such that the percent of state population living in SMSAs where fiscal disparities are severe is weighted once and the percent of population living in SMSAs where fiscal disparities are moderately severe is weighted 0.5. The categories of severe and moderately severe care based on average differences between federal general revenue sharing allocations for central cities and suburban areas. The differences in allocations were weighted by the ratio of noncentral city to central city population to adjust for the importance of the disparity. See the forthcoming ACIR report, *The Use of Federal Revenue Sharing Data for Measuring Central City-Suburban Fiscal Disparities.*

among communities in nonmetropolitan areas, but high disparity measures do suggest that a state has problems of unequal local financing abilities and/or expenditure needs.

There were six high property tax, high local responsibility states with less serious metropolitan fiscal disparities—New Hampshire, South Dakota, Nebraska, Colorado, Kansas, and Montana. These states need not be tied as tightly to the need-based revenue sharing solution, and can consider a wider range of options, including increased school support, state financing of welfare, and authorization of new local taxes. The latter may be a very attractive option if preservation of local autonomy is a high priority.

The list of factors used to distinguish among the states in Figure 2 is admittedly incomplete because it does not incorporate all possible considerations, and because conditions may have changed since 1977. For example, the data do not account for the full effect of recent targeted revenue sharing in states like New Jersey and Connecticut, nor recent Proposition 13-related state aid changes in California.

One of the additional policy factors that should be recognized is the financial ability of state governments to respond in a period of national fiscal restraint to the needs of their local governments. Some states may have all they can manage to balance their own budgets without tax increases, let alone assume the burden of financial conditions at the local level. Other state governments, however, may be in opposite circumstances. The list of states that are prospects for increased state sharing should be expanded to include those which are expecting future revenue gains as a re-

## Figure 2

# SELECTION OF STATES

| High Property Taxes | High Local Financing Responsibility | High Metropolitan Disparities | Low Metropolitan Disparities |
|---|---|---|---|
| Massachusetts | Massachusetts | Massachusetts | New Hampshire |
| New York | New York | New York | South Dakota |
| New Jersey | New Jersey | New Jersey | Nebraska |
| New Hampshire | New Hampshire | California | Colorado |
| Rhode Island | South Dakota | Oregon | Kansas |
| South Dakota | California | Connecticut | Montana |
| California | Nebraska | Michigan | |
| Nebraska | Connecticut | Maryland | |
| Connecticut | Oregon | | |
| Oregon | Montana | | |
| Arizona | Michigan | | |
| Vermont | Colorado | | |
| Montana | Kansas | | |
| Michigan | Maryland | | |
| Colorado | | | |
| Kansas | | | |
| Wisconsin | | | |
| Illinois | | | |
| Maine | | | |
| Maryland | | | |
| Wyoming | | | |
| Minnesota | | | |
| Iowa | | | |
| Indiana | | | |
| Alaska | | | |

sult of the rising value of their oil and mineral resources or other factors, even though their localities' fiscal stresses and financing inequalities may not be as severe as in other states. Some of these states, like those in the growing Sunbelt, have the opportunity to anticipate rising property taxes and increased local financing inequality and respond early before these conditions are created by high growth environment.

A discussion of a state-local revenue sharing proposal, in one such state, Utah, is reprinted as *Appendix B*.

Finally, as of 1979, 20 states had imposed limits on either total local revenues and expenditures or property taxes. In many of the states, local tax burdens are not high. However, the limits may make localities hard pressed to provide needed services. States that have taken these actions should consider whether they now have superior ability to finance needed local services and perhaps a responsibility as well to replace part of the revenue lost to local government. Expanded and need-based state revenue sharing is a good means of doing so.

# Selected State-Local Revenue Sharing Formulas In 1977

$\mathbf{T}$he following are descriptions of state-local 65
revenue sharing formulas used in 1976–77 in
states where funds were distributed according to
measures other than, or in addition to, origin
reimbursement and population. The primary
source for this information is U.S. Bureau of the
Census, Department of Commerce, *Census of Governments*, 1977, Vol. 6, No. 3, *State Payments to
Local Governments*, Washington, DC, U.S. Government Printing Office, 1979. The appropriate
state statutes are noted where they were used as
secondary sources.

## Alaska
(Alaska Statutes 43.18.010)

Alaska gave general aid to cities and boroughs
on the basis of the type of services provided by
the locality. In 1976–77 Alaska made the following per capita payments to cities and boroughs
providing the specified services:

| | |
|---|---|
| Police | $12.00 |
| Fire | 7.50 |
| Air Pollution Control | 2.00 |
| Planning | 2.00 |
| Parks and Recreation | 5.00 |
| Transportation | 5.00 |
| Hospitals | 2.00 |

Additional aid was provided on the basis of the
number of highway miles and the number of hos-

pital beds in a locality. Total payments to cities and boroughs in 1976–77 came to $16.6 million.

## Connecticut
(Connecticut Statutes 8.159a)

In 1976–77 Connecticut distributed $15.532 million to cities and towns according to a three-part formula: 10% on the basis of population; 50%, according to population adjusted by weight for density, to cities and towns with population densities above the state average; and 40% according to the number of public housing units. The formula was subsequently modified to provide for additional targeting.

## Georgia
(Georgia Statutes 69-1300, 69-1602)

Georgia distributed $13.5 million to its municipalities with the level of per capita aid adjusted inversely with respect to local population size.

## Hawaii
(Hawaii Statutes 246-6)

Hawaii distributed $21.6 million to the city-county of Honolulu and the counties of Maui, Hawaii, and Kauai. The allocation to each of the four counties is set at the amounts granted in 1972, unless a county function is assumed by the state. Prior to the adoption of the hold-harmless provision in 1973, state aid was based on each county's "relative fiscal capacity and relative fiscal need" as defined by the state legislature.

## Louisiana
(Louisiana Statutes 47:869)

In 1976–77 Louisiana distributed $31.4 million in tobacco sales tax receipts to municipalities according to per capita rates adjusted inversely to population size. Additional aid was provided to cities with populations in excess of 100,000. The state also distributed $322,000 to cities whose general fund receipts excluding federal aid and gasoline taxes were below a statutory amount.

## Maine
(Maine Statutes 30.5055)

Maine provided $9.9 million to its cities and towns in 1976–77 under its "state-municipal rev-

enue sharing" program. Aid was distributed in proportion to the product of local population multiplied by local property tax burden. The latter was defined as total local real and personal property taxes divided by local equalized property valuation.

## Maryland

Maryland distributed $10,000 to the City of Baltimore and a total of $4,000 to other counties in the state to make up the difference between the local income tax levy, and what a 1.7% tax on investment income and a .68% tax on other taxed income would raise.

## Massachusetts
(Massachusetts Statutes 58.18c)

Massachusetts distributed $41.7 million to its cities and towns in 1976–77 according to a formula based on population adjusted inversely for property tax base. The formula for aid can be shown as:

$$\text{Population} \times \$10 \times \frac{\text{Statewide per capita equalized assessed valuation}}{\text{Local per capita equalized assessed valuation}}$$

## Michigan

Of the $463 million provided by Michigan in general support, $35 million in single business tax revenues and $63.4 million in state personal income tax revenues were distributed to localities on the basis of population times relative tax effort. The latter was defined as the ratio of total municipal taxes, excluding special assessments, to local equalized valuation. An additional $10.1 million from the state's general fund was used to provide supplemental payments. $6.3 million went to communities under special census provision. Another $3.5 million went to communities benefiting from the relative tax burden formula. The latter included 25% of the taxes of overlapping jurisdictions in the calculation of aids. Finally, nearly $300,000 went to communities under minimum aid guarantees.

## Minnesota

Minnesota distributed over $171 million to localities in 1976–77 using a formula incorporating

tax effort and population. $45 per capita was allocated to each county area, with the seven-county Minneapolis-St. Paul metropolitan area treated as a single county. After the subtraction of hold-harmless aids, the remaining aids were divided among cities and towns in each county area according to population multiplied by the individual municipal mill rate, averaged over the preceeding three years, and the ratio of actual assessed value to true assessed value. This formula has been substantially changed.

## New Jersey
(New Jersey Statutes 54A:10 and 58:27d-178)

New Jersey shared $50 million with its cities, townships, and boroughs in 1976–77 from the state's revenue sharing fund. Aid was distributed on a per capita basis to all localities with an effective tax rate of $1 per $100 of true valuation.

New Jersey also distributed $38.9 million to all municipalities having the following characteristics:

1) a population in excess of 15,000 or a population density exceeding 10,000 per square mile;
2) an AFDC school age population exceeding 350;
3) existing publicly financed housing;
4) an equalized tax rate above the state equalized average;
5) per capita equalized valuation below the state equalized average.

Funds were divided among eligible localities according to the following formula:

$$\text{Aid Factor} = .6 \left( \frac{\text{local AFDC student population}}{\begin{array}{c}\text{sum of AFDC student}\\\text{populations for}\\\text{eligible communities}\end{array}} \right) + .4 \frac{(T)}{(\epsilon T)}$$

Where T equals $P(Vs - Vm) \times (Rm - Rs)Z$

P equals municipal or township population.

Vs equals statewide equalized valuation per capita.

Vm equals municipal or township equalized valuation per capita.

Rm equals municipal equalized tax rate.

Rs equals statewide equalized tax rate.

Z equals the proportion that residential and apartment assessed valuation bears to total assessed valuation of the municipality or township.

$\epsilon T$ equals the sum of all Ts for eligible municipalities and townships.

## New York

In 1976–77 New York shared $718.6 million, the 18% of state income tax receipts earmarked for this purpose, with its counties, cities, villages, and towns. Of this amount, half was distributed to governmental units classified as "cities." The remainder was distributed to all general purpose local units according to specified per capita amounts for each government type, with amounts adjusted inversely for property tax wealth, and in the case of counties, for per capita income. The specified per capita amounts for 1976–77 were:

| | |
|---|---|
| Cities | $8.60 |
| Villages | 3.60 |
| Towns | 3.55 |
| Towns Outside of Villages | 2.05 |
| Counties | .65 |

After the initial allocation, the remaining funds were distributed in proportion to the amounts received in the initial allocation.

## Wisconsin

In addition to its large per capita and reimbursement-based payments, Wisconsin provided $292.2 million in need-based aids to its counties, cities, villages, and towns in 1976–77. Of this amount $93.9 million was distributed according to the "aidable revenues" formula. The latter bases aids to localities on most of their own source revenues, weighted inversely for property tax wealth.

Adjustments to the aidable revenues, and other payments from the shared tax account totaled $4.8 million.

Finally, $193.6 million in general property tax relief was provided to communities in proportion to the excess, if any, of all local property taxes resulting from a total effective property tax rate in excess of 50% of the statewide average. This was applied as a credit to property taxpayers' bills, rather than as a direct payment to local governments.

# Forward

The following reprinted paper, by Robert P. Huefner and Stephen Seninger of the University of Utah, is the concluding chapter in the 1979 Report of the Seminar on State and Local Revenue Sharing, "Revenue Sharing: New Challenges for State and Local Governments." The seminar was sponsored by the University's Institute of Government (now the Center for Public Affairs and Administration, and The Institute for Human Resource Management).

The seminar was convened and the report prepared in response to concern in Utah over the public service pressure expected on local governments due to population and economic growth, the opportunity to address the problem of local fiscal inequalities before they strongly affected patterns of development and grew worse, the western property tax limitation movement, and the uncertain outlook for federal aid. These concerns were partly identified in the 1973 Utah Local Government Finance Study which surveyed government, taxpayers' groups, and university officials and documented disparities in per capita local property tax bases and sales tax revenues.

Although the broad reasons why a state can benefit from state revenue sharing were identified in the preceeding report, a full analysis of the future potential for such programs in each state was not possible. In order to recognize the importance of this task, we have appended this paper.

**John Shannon**
**Assistant Director**
**Taxation and Finance**

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# The Uneasiness Of Revenue Sharing

**F**ederal revenue sharing is in trouble. Yet many, perhaps most, local governments have continuing and increasing needs for revenue sharing programs. Given these circumstances, the burden and management of revenue sharing is shifting to the states, which control the fiscal structures of both state and local governments. It is important that state leaders understand, and consciously direct, how the choices which will shape these fiscal structures will in turn determine future revenue sharing programs.

These concerns and presumptions guided the University of Utah's 1979 Seminar on Revenue Sharing. The participants recognized that they were dealing with presumptions. But, unfortunately, certainty comes only after the future (and our chance to influence it) has passed us by. So, believing that wisdom is not in waiting for certainty but is in seeking presumptions reasonably supported by available knowledge, we found that the political and financial evidence supporting the above presumptions justify using them to spot and study the key decisions which are before us.

We outline here three types of conclusions which seem justified by the seminar's papers and discussions. One type describes trends and issues. They serve as the headings, and hence as the organizational structure of this paper. Another, and perhaps the most important, type of conclusion sets forth proposed guidelines for public policy. These are in boldface type throughout the paper. A final type of conclusion suggests needed re-

search. These are italicized as they appear in the paper.

We offer these conclusions with tentativeness, because the analysis is a preliminary look at an uncertain picture. The revenue sharing picture is clouded because it is uneasy in two important respects. First, it is unstable at the federal level where revenue sharing is a burden riding precariously upon the federal treasury. It also is uneasy because the states find the setting of revenue sharing policy to be a politically-not-easy task. Revenue sharing is not only economically burdensome, but also is filled with the sharp political conflict of income transfers, with every winning matched by a loss, always adding to the pain of the load. Thus, altogether, the uneasiness means that the usual level of uncertainty is compounded by the transition in the federal role and the uncertainty as to whether various states will act, how soon they will act, and how they will act.

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## The Burden of Revenue Sharing is Shifting to the States

Federal revenue sharing appears headed toward decline because the total federal revenue system has become so burdened. The situation is not one of a less productive revenue base at the federal level. It is rather that the corporate and individual income taxes have been saddled with a much broader set of federal programs and are likely to be expected to help cover the increasingly expensive Social Security program, either through direct contributions or through tax cuts to compensate for increases in the Social Security tax. At the same time a growth of tax expenditures (exemptions, deductions, exclusions, and other tax preferences) is sapping some strength from the federal income taxes. Besides reducing the equity of the taxes (in terms of treating persons with similar incomes similarly, and also in terms of the extent to which the taxes adjust the burden for income levels) the tax expenditures may be reducing the extent to which revenues increase with growth in the economy. It is understandable that, with increasing demands upon the federal revenue system, Congress will be less inclined to support programs for which its own political payoff is small, as it is in the case of general revenue sharing. This reluctance comes whether or not Congress also is irked with the states' Governors and legislators (their most probable future political opponents) for the pressures and polemics of a proposed Constitutional limitation on federal spending.

## Local Governments' Need for Revenue Sharing Continues, and Probably Grows

Yet with the leveling off or decline of federal revenue sharing, the needs for financial assistance for many levels of government continue, and in some cases grow. The disparities between governmental units, particularly in urban areas, tend to be self-perpetuating. The situation is inherently unstable because once a unit of government has a stronger tax base than a neighboring unit it is given a competitive advantage in attracting other development having favorable tax characteristics. Circumstances may shift, and public policy may help that shift, as now appears to be happening in some central cities.[1] But overall there is a tendency for the rich to get richer while the poor become poorer.

A second form of disparity occurs from growth, particularly growth that is related to resource development. Local property tax bases may explode as the value of a mine or an ore field is established. But neighboring rural and urban jurisdictions will not share in this tax base, even though these jurisdictions may share, or even shoulder most of, the burdens of the development.

A third disparity results from the uneven timing of revenue inflows and community needs, especially in municipalities which are experiencing rapid change in size, whether an increase or a decline. In growth communities, front-end costs are frequently high, not only exceeding current revenues but also frequently exceeding what can be supported by the legally allowable bonding. On the other hand, declining areas are likely to lose their tax base before they lose the demand for services. While the relationship between the tax base and the services may eventually reestablish a balance, it is not likely soon to be able to repay the extra costs required during the decline.

In addition to correcting for disparities, revenue sharing is needed as a mechanism to better adjust the overall balance in the tax system. The property tax is in many ways the most appropriate tax for local jurisdictions in terms of dependability and in terms of minimizing the incentive or capability to move the tax base away from the taxing entity. But a balanced tax system depends upon

a mix of taxes which together create fairness among those of similar incomes and among those of differing incomes. This is likely to require a mix of taxes and thus require the levying of the taxes at various levels of government. Revenue sharing is a means to link a balanced tax system with the revenue needs of the various levels of government most appropriately providing services.

With the federal government playing a smaller role, the responsibility will fall to the state and to subordinate units such as counties to provide this revenue sharing linkage. In both cases the states, and most particularly the state legislatures, must carry the primary responsibility for establishing and adjusting the system. The legislature established the state revenue sharing programs and also must provide the legislation to enable, and probably in most cases to mandate, any effective revenue sharing that takes place at the metropolitan or county level.

## There are Many Approaches to Revenue Sharing

A review of state and local revenue sharing possibilities shows that there are many tools available providing a surprisingly broad range of approaches to revenue sharing. These tools include not only direct general revenue sharing and categorical aids but also the shifting of responsibilities between levels of government. In addition, they include adjustments in the tax and revenue system of one level of government in order to make possible other adjustments in taxes and revenue for other levels. Just as federal reductions in the individual income tax have been used to allow the political room for increases in the Social Security tax, reductions in state tax levies on property or income can provide the room for increases in local tax levies.

Too little is known about whether or not the politics of the situation actually allows a flexible and purposeful choice among the optional state strategies. Analyses are needed of how various tax relief strategies fit within or affect a revenue sharing policy, whether or not these strategies are done with purposeful consideration of that policy. But equally important is a better understanding of how or to what extent the politics can accommodate a purposeful strategy of revenue sharing within the broader policies of the state and local tax systems. The need to understand more fully the political forces and policy processes of revenue sharing might best or at least initially, be met by case studies of how the various legislatures consider revenue sharing policies.

## Revenue Sharing as a Mechanism to Equalize Community Financial Capabilities

**Ideally, a revenue sharing strategy would equalize, for the average costs of a particular level of service, the economic burden upon taxpayers of similar financial means in the various jurisdictions.** This is an equalization of a jurisdiction's tax capacity, and not of tax effort. In other words it would not strive to equalize the amount of money spent by each jurisdiction. Instead, it would seek to assure that when the voters of one jurisdiction considered increasing their support for a particular service, the resultant change in tax burden upon them as residents of their jurisdiction would be equivalent to the change in tax burden from the same variation of support in other jurisdictions. (Perhaps such equalization could be carried too far, in that total equalization would eliminate the incentive for local jurisdictions to accommodate and serve commercial and industrial development. But foreseeable revenue sharing programs would not go so far. They would only move toward the objective of equalization and would leave a significant reward in tax base for those jurisdictions having commercial and industrial properties.)

Measuring the relative economic burden, as Keifer and Smeeding point out in their paper, is very difficult. The property tax mill levy, for example, does not take account of sales, franchise, and other taxes or of special fees. Thus a high mill levy may reflect greater than usual reliance on the property tax rather than a particularly heavy burden upon local taxpayers. If a large proportion of a jurisdiction's assessed valuation is on property owned by outsiders, the jurisdiction well might concentrate on this tax. A one-mill increase in tax still means the same to a home owner, but if such a levy produces high revenues per capita, it offers the residents more service for their dollar and reduces the need for other taxes and fees, which a more typical community might impose for the same service in order better to balance the tax burden. Thus the mill levy may not reflect relative

tax burden. Similarly, it may not distinguish between communities in terms of relative need, as it may not separate the big spenders from the real needers.

Still, a first best measure probably is the property tax mill levy. It is easily available and, except in those communities which have a significant local income tax paid by their residents, is a fair indicator of relative burden and probably also of relative effort inasmuch as the biggest disparity between communities is in terms of tax base, and not in terms of spending levels.

A more refined measure would provide a per capita, or per family, property tax base adjusted for the jurisdiction's probable collections from outsiders. This goes beyond a simple comparison of tax value of properties within the jurisdiction. Two jurisdictions may have the same property tax base per capita. But if one jurisdiction has more access to outside funds, say through a sales or income tax it levies on outsiders or through grants-in-aid it receives from other levels of government, it can provide a similar level of service without levying as high a tax on the resident property owner. This measure is much more difficult to make. *A more refined measure of relative tax burden deserves careful study.* In the meantime, the property tax mill levy can be used as as approximation of economic burden.

The disparities between urban jurisdictions, and even between those areas having natural resource property values and those areas without them, appear to be not as great in Utah as in many states. But the disparities exist and, as Dyner points out in her paper, probably are growing. In the urban area they are growing because they build upon themselves; in the rural areas disparities develop as the energy shortage prompts resource development.

This leads to two conclusions. The first is that **the state ought to address the question of a revenue sharing policy as soon as possible inasmuch as adoption and implementation are likely to be easier before the disparities are large.** While statistical evidence has not been gathered to show that sooner is easier, the presumption seems justified on two grounds. First the experience at both state and federal levels with adjustments in intergovernmental financial assistance has been that the politics requires hold harmless provisions. This means that the adjustments can only deal with future disparities, and thus long-term equit-

ability depends on the future eventually swamping the past in scale. This will take much longer as the disparities grow larger. Therefore the solutions will be more complete and perhaps can be less drastic if they are made at an early stage. The second reason is that the disparities themselves create special interests; the larger the disparities the stronger the interests and the more reason they have for fighting adjustment.

The second conclusion is that *a regular monitoring of the tax base disparities among local jurisdictions would be very helpful.* Enen if this were begun with a crude measure of property tax mill levy, it would provide some idea of whether or not the problems are actually worsening and whether or not adjustments are actually helping. More refined measures would, of course, substantially improve the value of the monitoring.

While it is difficult to measure relative tax burden, it is even more difficult to measure relative need for revenues among various jurisdictions. Yet any revenue sharing program must establish some basis for distributing funds, and usually the presumption is that this should be some measure of need. Population, although the most common measure, is not a total measure of the demand for services, especially social services. But other measures of the need for social services are difficult, both to make and to agree upon. However, in Utah, and to a considerable extent in other states, the problem is reduced by the extent that social services are financed by the state. While such state financing may create problems of centralization, the 1969 ACIR study of state aid to local government and more recent work by Betsy Levin suggest that it is possible for the state to provide the major financing for local services without necessarily assuming major control.[2]

**The shift to the state of the burden of financing social services seems appropriate, because of the benefits which the services provide beyond the boundaries of a jurisdiction and because of the difficulties of financing these services within the smaller jurisdictions.** The benefits beyond the boundaries of the jurisdiction (the externalities) are of two types. One is where the service, such as education, is expected to benefit society in general through its benefit to the individual. After graduation the student is likely to live in another jurisdiction, and as a member of its work force and of its society to be a better contributor to that jurisdiction and to the state in general. While this

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perhaps is a sound economic reason for the state's role, the real reason that the state assumes much of the burden of education probably is a general commitment to education and a recognition that the local revenue base is, in many situations, insufficient.

The other type of externality is where the burden may have originated in another jurisdiction. Welfare and social services are examples, in that persons needing special help tend to congregate in particular jurisdictions although they may have originated in a number of other areas outside its limits. The problems they face result from the general structure and capability of the society, rather than having been caused by the jurisdiction in which they happen to reside or to which they happen to go for help. Again the real reason for the sharing is likely to be something less theoretical. Indeed it is a combination of political pressures for more, and more certain, delivery of these services. It probably also reflects a concern that virtue does not have its own reward but penalizes the government providing such services by attracting more of those in need.

With the state's assumption of the costs for education and social services, the remaining services generally do relate to the population or tax bases. For those related to tax base (for example, special police and fire protection for commercial and industrial properties), the present and foreseeable tax structures provide at least the additional tax resources the community needs to finance the services. **For those services for which demand is related to population, a revenue sharing strategy that moves to a general equalization of economic burden per dwelling unit permits local control and supports local choice in relative levels of service.** It is more appropriate in these cases to keep such controls at the local level and allow the citizens to select their services by choosing their place of residence within a metropolitan area. Only at the local level does the citizen have much opportunity to vote with his feet by moving to the jurisdiction which most closely agrees with his philosophy of public services. Choices between states or between metropolitan areas are not nearly so open. But within a metropolitan area, the family can be offered a choice of jurisdictions and thus a choice of governmental service philosophies.

These conclusions lead to a further conclusion that **general, rather than categorical, revenue sharing is most appropriate.** The purpose of the revenue sharing, if the objective is to allow public choice in public services, is not to assure particular services, but to establish a more equal economic burden of a tax levy by the various jurisdictions. The assurance of minimum standards of services such as those provided through water and sewer systems are probably more appropriately handled by means of regulation than through categorical financial assistance.

There are two types of disparity which such revenue sharing should address. The first is that which occurs within a metropolitan area because of the urban segregation by economic level and because of industrial and commercial tax bases. The other is the disparity in resource wealth which particularly occurs among rural jurisdictions.

The urban segregation, both within a metropolitan area and between nearby suburbs and the metropolitan area, creates special problems of tax-base competition. The jurisdictions are pressured to compromise development standards and zoning ordinances in order to attract the tax base which in turn will either strengthen their competitive position for a future tax base, or protect them from beginning the downward spiral of a low tax resource community whose tax burdens discourage location by the commercial and industrial properties which have choice in their location. **In the case of urban segregation of tax base resources, a system of tax-base-sharing appears most appropriate.** Where counties are large, as they are in Utah, this might best be done at the county level, requiring state legislation but not state administration.

If politics do not allow tax base sharing, then the state revenue formulas may help. For example, Utah's recently enacted income tax rebate, based upon property taxes paid, while admittedly helping rich individuals more than poor, is on the other hand particularly helpful to the tax base poor (i.e. heavily residential) jurisdictions. By easing the tax burden on the residences without reducing the tax take by the local jurisdictions, the state has increased the tax capacity of residential property for the local jurisdictions. If the state had instead required a reduction in the property tax levy as the mechanism to assist residential property owners, the jurisdictions most dependent on residential properties would have been particularly hurt.

Disparities that result from differences in resource wealth do not necessarily have much relationship with the services required. The resource may be in one jurisdiction and the population involved in extracting the resource may live in a completely separate jurisdiction.

Two adjustments through revenue sharing policy appear appropriate in these cases. **In order better to relate the tax wealth of natural resources to the jurisdictions which are carrying the burden of services related to that resource, tax base sharing within a county should be used where the counties are large, and multicounty tax base sharing can be used where the counties are small.** The second adjustment relates to the fact that much of the tax collection from the resources could go beyond that needed to service the particular resource. In this case the resource is a point of wealth being taxed to support general government services. **Because the tax wealth is usually very great in cases of natural resource development, a portion of the tax revenue should be distributed on a statewide basis rather than on the basis of those jurisdictions which happen to be in closest proximity. This argues for state taxes such as severance taxes and mineral lease payments, and argues that they then be used for general state purposes or general state revenue sharing.** *There is a need for a better understanding of just what service costs are related to resource development.* With that understanding it would be possible better to outline mechanisms to deal with both purposes of taxes on this wealth.[3]

### State Help in Adjusting for Uneven Timing of Needs and Resources

In Utah the problem of uneven timing is, at least at present, essentially in those situations of rapid growth. The heaviest burden probably relates to the financing of school construction. Here the state government already assumes a major role. To the extent that this role increases, it will solve the problem of capital costs related to rapid growth. The state similarly assumes responsibility for major roads, and thus takes care of another major capital cost. Other costs, for local streets, for water and sewer lines, etc., are local costs, and decisions and management are appropriately kept as matters of local choice.

In the case of rapid growth, the problem is not that the tax resources will not be available but

rather that they come late and that mechanisms are needed for the heavy front-end costs. **The appropriate state role in the case of uneven timing of financial needs and resources is to provide the capability for such communities in bond for the front-end costs, rather than for the state to provide grants for these costs.** This may require some adjustments in debt limits for rapidly growing areas. A state bond bank would also be helpful to the smaller communities. In instances of very rapid and large developments these steps will not be nearly enough. Further help could come from a revolving fund for direct state loans, a form of which has been established in Utah, and should be a useful aid if carefully managed. Aid also could take the form, as it has in Utah, of allowing advance payment of taxes by the industries causing the growth in order to provide the front-end costs. However, **further study is desirable to investigate whether the advance payments of taxes have, in effect, been used as a mechanism to divert the taxes from public expenditures to expenditures which directly service the industry involved.** Would these expenditures have been the responsibility of the industry, and would they have been classified as private expenditures?

### Revenue Sharing Policy as an Aspect of a Balanced Tax System

An additional conclusion drawn from the review of the possibilities for state and local revenue sharing is that **revenue sharing is a useful, and perhaps essential, part of a strategy for a balanced tax system.** This depends on the presumption that some kind of balance in the tax system is valuable. There is no equation which argues for a particular mix of taxes. The argument for a balanced tax system is more empirical. It builds on the fact that each tax inevitably, although unintentionally, has its own set of loopholes. Thus heavy dependence on one tax will make its loopholes particularly valuable and create particularly strong inequities. It is a matter of spreading the burden through several taxes where the loopholes will be different, somewhat distributed, and not a free ride for any select group. It is the difference between a solid piece of swiss cheese with a hole big enough for a finger to pass through or a stack of slices where the holes do not fall in line. It is like the strength that comes from a laminated wooden beam which keeps the knots

and the weak spots from being concentrated. The argument for a balanced tax system also builds on stability as each tax has its own peculiar responsiveness to economic change. A mix of taxes is more stable and less sensitive to short-term adjustments in the economy. Finally it builds on the equally inevitable fact that each tax has its own problems, as, for example, the tax competition between jurisdictions for property tax base. Heavy reliance on a particular tax would increase the problems associated with that tax.

While there thus are good arguments for a balanced system, there still is no certain guide as to what balance is most appropriate. In fact, since one of the problems is interjurisdictional competition through the tax system, the appropriate mix depends in part upon what the mix is in other jurisdictions. Utah's present mix places a burden on each of the major taxes which is fairly close to the national average. Thus **while there is no clear or best balance of taxes, Utah's present balance, which approaches national averages, seems reasonable.**

This in turn leads to the conclusion that *Utah's policy should be to correct the problems of the property tax rather than to replace it.* Utah's dependence on the property tax is not great compared with other jurisdictions. In fact, it falls below the national average. But it does have the problems associated with the property tax across the country.

**Utah should make more effort toward assessment uniformity, to improve the equitability of the property tax.** A related step is that **Utah should institute a real estate transfer tax in order to provide more complete and certain data on real estate properties as a basis for more uniform assessment.** The real estate transfer tax was originally levied by the federal government and performed this very function. It was removed several decades ago as a policy of fiscal federalism, with the specific purpose of giving up a federal revenue source which might be taken over by the states. However, several states—Utah included—did not pick it up. There has been an understandable resistance to the tax from the real estate industry. But the burden of the tax need not be large either in terms of the tax itself or the administrative problems. And administrative burdens at least as great must be established if the assessments are to become more uniform.

**There should be regular (annual) adjustments in property assessment.** To keep these adjustments from providing a free ride to higher taxes by local jurisdictions the **adjustments in property assessments should be coupled with indexing and a truth-in-tax law.** The indexing would require that mill levies automatically be lowered whenever the increase in assessments outstrips the general growth of the economy and of inflation. The truth-in-tax law would require that any increase in the mill levy, including upward adjustments after the indexing had reduced the levy, be made only after well-publicized notice and hearings, as are now required in Florida.

Another adjustment that might improve the property tax would be that it be paid quarterly. For homeowners who pay the tax directly this would reduce the problem of the large annual lump sum. In the case of financial institutions which are collecting the tax from their borrowers, and then paying it at the end of the year, it would give the public agencies the use of the money throughout the year rather than only at the end.

Finally, a couple of conclusions indirectly related to revenue sharing deal with tax policy in general. The first is that if tax limitations are used, **a limitation on total revenue offers considerable advantages over restrictions on particular taxes.** It better supports a balanced tax system and leaves greater flexibility in the design of revenue sharing programs. A second conclusion is that any adjustments to the sales tax law are likely to have important impact on revenue sharing. Besides the obvious question of whether the sales tax is distributed on the basis of population or point-of-sale, *there is need to study the question of what a food exemption would do to total revenues and to the jurisdictional distribution of these revenues.* The sales tax exemption issue is likely to remain. It becomes a bigger issue as the sales tax increases. Utah now has the highest sales tax rate in the country for a state which does not provide the food exemption. Wherever the sales tax is over 5 percent it also is coupled with the exemption. Other pressures for change come from the fact that the distribution of the sales tax at point-of-sale once provided an offset to the double taxation which municipal residents were paying where counties provided urban services in unincorporated areas. Correction of the double tax problem also removes that justification for distribution sales taxes according to the points of collection. The exemption of food would further concentrate

the point of collection of the revenue in the larger commercial centers. Distribution on the basis of population would eliminate the disproportional effects of the exemption of food in the sales tax.

## State Action Will be Limited if it Depends on Consensus

While appearances may be otherwise, Utah state legislators seldom look for conflict, but instead seek to avoid it. In matters of local government, the legislature usually acts to give legal confirmation to a consensus previously reached by the local governments. When the governments are in conflict, the legislature is inclined to defer action, urging the governments to "get their acts together" if they expect the 60-day session to take action on their needs.

Revenue sharing is basically in conflict with consensus. It represents the taking of revenue from one jurisdiction and bestowing it upon another. Consensus can hardly be expected for such a program, with the possible exception of that directed toward uneven timing in expenditures where the sharing essentially gives funds to one jurisdiction which will be replaced by later tax revenues from the same jurisdiction. Thus a state revenue sharing policy must inevitably be forged through conflict.

The legislature simply cannot take on all political battles, especially in any given year. But it must take on some. So the question is whether or not revenue sharing deserves the allocation of the significant political resources required for the shaping of a comprehensive policy. Our final conclusion is an emphatic yes: as only the states can, **the states should take on the political burden needed to develop a balanced revenue sharing system.**

While some action might best be directed at revenue sharing at the national level, major political battles should be faced by the state legislatures. Both because the federal government appears not likely to assume the necessary responsibility for developing a comprehensive program, and because the state governments are the more appropriate location (being closer to the problem and being able to design a variety of solutions in various parts of the country), the state should take on the burden of the political battle.

## FOOTNOTES

[1] T. D. Allman, "The Urban Crisis Leaves Town, and Move to the Suburbs," Garoers 257 (December 1978): 41–56.

[2] Advisory Commission on Intergovernmental Relations, State Aid to Local Government, Washington, DC 1969. Betsy Levin and Michael A. Cohen, Levels of State Aid Related to State Restrictions on Local School District Decision-making, Washington, DC: Urban Institute, 1973.

[3] Katharine Lyall recently summarized the progress, issues, and findings regarding tax-base sharing. Her paper and the work it summarizes (for example: Provincial-Municipal Finance Council, Tax Base Growth-Sharing Program for Alberta, July 1976, which is particularly concerned with natural resource developments) provides a starting point.